USE OF SECTION 936 FUNDS FOR LOANS IN THE CARIBBEAN REGION

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

APRIL 3, 1990

Serial 101-97

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE

31-742 WASHINGTON : 1990

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

Y 4.W 36/1:101-97

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USE OF SECTION 936 FUNDS FOR LOANS IN THE CARIBBEAN REGION

TUESDAY, APRIL 3, 1990

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:36 a.m., in room 1100 Longworth House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
FRIDAY, MARCH 23, 1990

PRESS RELEASE #25
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-5522

THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN,
SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES A HEARING ON THE USE OF SECTION 936 FUNDS FOR
LOANS IN THE CARIBBEAN REGION

The Honorable J. J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold a hearing to review the use of funds held by Puerto Rican financial institutions, pursuant to Section 936 of the Internal Revenue Code, to fund investments in active business assets and development projects in the Caribbean region.

The hearing has been scheduled for Tuesday, April 3, 1990, beginning at 9:30 a.m., in the main Committee hearing room, 1100 Longworth House Office Building. Witnesses invited to appear at the hearing include representatives of the Department of the Treasury, the Government of Puerto Rico, eligible Caribbean Basin Initiative (CBI) countries, associations representing U.S. corporations doing business in Puerto Rico, and banks holding "936 funds" in Puerto Rico.

Section 936 allows U.S. corporations doing business in Puerto Rico to invest and earn tax-free interest income on profits they earn in Puerto Rico. In 1984, the Department of the Treasury proposed the repeal of Section 936 and substitution of a wage credit. In response, the Government of Puerto Rico proposed to the House and Senate tax-writing Committees that Section 936 be retained and expanded to provide for investments of 936 funds in CBI countries. During Committee deliberations on tax reform in 1985, the Government of Puerto Rico provided a draft memorandum of agreement outlining its proposal for making $100 million of 936 funds available to such CBI countries each year.

In announcing the hearing, Chairman Pickle stated: "There are $10-$15 billion in tax-free investments by U.S. corporations in Puerto Rico taking advantage of Section 936. Prior to 1987, tax-free income on invested profits from Puerto Rican operations could be derived only from sources inside Puerto Rico. In the Tax Reform Act of 1986, however, the Congress amended the law to allow for tax-free treatment of investments of 936 funds outside Puerto Rico. This change in the law was made to enable Puerto Rico to implement its proposed Caribbean loan initiative. In this initiative, Puerto Rico proposed to use loans of low-interest 936 funds to increase investment and employment in qualified CBI countries.

"Both the House and Senate Committee reports accompanying the Tax Reform Act of 1986 describe the importance of Congressional oversight to review the operation of Section 936. The amendment to Section 936 has been in place now for over three years. It's time Congress takes a look at what has happened in the CBI region, through December 31, 1989, and to date, as a result of the Caribbean loan initiative. At the Subcommittee hearing, we will determine how much in 936 funds has been in fact made available in loans to eligible CBI countries, exactly how that money has been used, and whether the program is effective or changes should be made."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Interested parties are urged to submit written comments. Persons submitting written comments for the printed record of the hearing should submit six (6) copies by the close of business, Friday, May 4, 1990, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102 Longworth House Office Building, Washington, D.C. 20515. Parties interested in making copies of their written statement available to the Subcommittee and the public at the hearing should submit 100 copies of their written statement, as outlined above, by the close of business, Friday, March 30, 1990.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Chairman PICKLE. The subcommittee will come to order. Now, that it is 9:36 on the clock, we will now open the section 936 hearing. Our first witness this morning will be our distinguished friend, Ken Gideon with the Treasury Department. But before you proceed, Mr. Gideon, we have a few statements to make up here. So we will make these opening statements by any members who want to make them.

The Subcommittee on Oversight meets today as part of its investigation into the implementation by the government of Puerto Rico of the so-called Section 936/CBI loan program. Under present law, U.S. corporations doing business in Puerto Rico receive a credit that eliminates all the U.S. income tax on the profits they earn there. The credit applies not only to the profits they earn from conducting business, but also to investment income from funds they retain and invest in Puerto Rico. These invested funds are referred to as 936 funds. The section 936 tax credit creates a Federal revenue loss of almost $2 billion annually.

There are $10 to $15 billion in 936 funds on deposit, or otherwise invested, in Puerto Rico. This is more than the Federal Government spends on elementary education or higher education or the space program. The question before the subcommittee today is, do eligible Caribbean countries have, in fact, meaningful access to these funds as provided for by law and promised by the government of Puerto Rico? Or are there better ways for Puerto Rico to run the Caribbean loan program? Should we look at changes in the section 936 program?

During consideration of the Tax Reform Act of 1986, Puerto Rico made a commitment to this committee, to the Senate Finance Committee, and the Department of Treasury, a commitment to guarantee $100 million of new investments annually to the Caribbean Basin Initiative countries. To enable Puerto Rico to implement this commitment we added a new provision to section 936, subsection (d)(4), allowing Puerto Rico financial institutions to make loans for investments in active business assets or development projects in qualified CBI countries. We made this change because we felt that Puerto Rico, the most affluent of the Caribbean islands, had a special responsibility to assist in the economic development of the less-developed CBI countries.

Now, I know that many of the members sitting here today clearly recall the events that took place in early 1985–86. During tax reform, the Department of Treasury proposed, in Treasury I, that section 936 be repealed and replaced with a wage credit. In response, the government of Puerto Rico and the 936 corporations lobbied for retention of 936. In exchange, Puerto Rico promised to implement a program that would make $100 million of 936 funds annually available to the Caribbean region. Both Puerto Rico and the prior administration initiated the 936/CBI program and when the Congress agreed, Puerto Rico became the broker for a big pool of Caribbean development funds.

Over 3 years have passed since 936 was amended to allow for the 936/CBI loan program. In the first 3 years since enactment, as of December 31, 1989, loans of 936 funds by Puerto Rican financial institutions to eligible CBI countries totaled only $70 million. In the 3 months prior to this hearing the loan amount has more than dou-

bled. No loans have been made to date by Puerto Rican's Government Development Bank. Also, questions have been raised about whether the projects financed with 936 funds are the type of projects that Congress intended.

Let me reemphasize two important facts. There are currently $13 billion in tax-free 936 funds on deposit or invested in Puerto Rico. Investment of $100 million annually, is less than 1 percent—0.8 percent to be exact—of the $13 billion of 936 funds available. Investments of $100 million in CBI countries would leave plenty of 936 funds available for productive use in Puerto Rico. It is hard for some of us to understand why loans of 936 funds have only trickled out of Puerto Rico.

This will be the first subcommittee hearing on this matter. Our intent today is to get the facts. I believe that the facts will speak for themselves. Among other things, I expect to clarify exactly what Puerto Rico understands its commitment to be and exactly what the Congress is to expect in the future. I hope to schedule additional testimony at a later date on this subject.

Now, the Chair will recognize Mr. Schulze for an opening statement.

Mr. SCHULZE. Thank you, Mr. Chairman.

I am pleased to join you in opening our hearing on the use of section 936 funds in the Caribbean region. The original motivation behind section 936 was to provide a tax incentive for corporations to establish business operations in the possessions and territories of the United States.

Such business activity can be helpful in supporting the local economy and creating jobs. This is a praiseworthy objective. As a matter of fact, it is an objective shared by every State and local government in the United States. However, the State and local governments cannot offer the benefits of section 936 to corporations which locate in their jurisdictions.

There are provisions in the Internal Revenue Code which provide a tax incentive to foster some economic objective. Section 936 pushes this general feature to the extreme. The revenue loss associated with section 936 thus far has been out of line with the jobs that it helps create.

Reports show that the revenue loss from section 936 is greater than the wages paid to the persons employed by section 936 corporations. Section 936 was sold to us as an instrument of foreign policy in the Caribbean region, not as sound tax policy. In particular, the government of Puerto Rico urged the retention of section 936 in return for a commitment to invest at least $100 million each year in economic development in the Caribbean region.

Today the subcommittee will review the operation of 936, after the Tax Reform Act of 1986. The tax benefits of 936 to corporations doing business in Puerto Rico are very tangible. They total $1.9 billion in 1989. However, the Caribbean economic development which was supposed to accompany the new section 936 has been much less tangible. We truly want Puerto Rico to become the anchor of economic leadership in the Caribbean. However, so far the trickle down of section 936 benefits to Caribbean development has been extremely slow.

What are the reasons for the slow pace of the Caribbean development activity under 936? What can be done to promote the vigorous use of section 936 to serve as an anchor of development in the region? If section 936 proves to be unworkable, or ineffective in Caribbean development, then we might question the justification for retaining it. The United States might be better off to trim back 936 benefits and let the State Department and the Appropriations Committees use the revenue savings to fund direct foreign aid projects in the region.

Mr. Chairman, the future of section 936 will be strongly influenced by its current track record. The subcommittee should prepare a report card on section 936. Today's witnesses can help us evaluate what grade should be presented.

I look forward to hearing today's witnesses.

Chairman PICKLE. Thank you, Mr. Schulze.

Any other Member have any opening statement?

[No response.]

If not, then Mr. Gideon we are pleased to have you here and we are looking forward to your testimony.

If you will proceed, sir?

STATEMENT OF HON. KENNETH W. GIDEON, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. GIDEON. Thank you, Mr. Chairman.

Mr. Chairman and members of the subcommittee, I am pleased to be here today to address this subcommittee on the status of the section 936 program in the Caribbean Basin Initiative countries.

Section 936 of the Internal Revenue Code effectively grants an exemption from Federal income taxes on certain income earned by electing U.S. corporations doing business in Puerto Rico. The exemption applies to the corporation's active business income from Puerto Rico and a certain passive income from Puerto Rican sources called QPSII, or 936 funds. It is estimated that the Puerto Rican banking system currently holds almost $10 billion in section 936 funds.

The Tax Reform Act of 1986 added income derived from certain investments in qualified CBI countries to the definition of QPSII. Prior to that time, QPSII funds could only be invested in Puerto Rico. This change was perceived to be a means by which Puerto Rico could share its benefits under section 936 while the United States furthered CBI objectives. In the course of developing the legislation the Puerto Rican government pledged to make a good faith effort to make $100 million in these section 936 funds available for CBI purposes each year. Since enactment of the 1986 act, approximately $167 million has been lent to projects in CBI countries under the program.

Congress placed clear limits on which CBI countries and what projects in those countries would qualify. Thus, only CBI countries having effective tax information exchange agreements with the United States are eligible to use 936 funds. The tradeoff required is quite explicit. CBI tax benefits are not available for economic development where the economy is being aided or relies on tax haven activities. The administration supports this fundamental policy.

The last few months have seen an encouraging trend in tax information exchange agreement activity. Until September of 1989, we had effective TIEA's with only four CBI countries: Barbados, Dominica, Grenada, and Jamaica. In October of 1989, a TIEA with the Dominican Republic went into effect and in February of this year, an agreement with Trinidad and Tobago became effective. In addition, our TIEA with Costa Rica is in the ratification stage in Costa Rica and we anticipate having a TIEA with Guyana shortly.

Congress also provided that 936 funds may be used only for investments in active business assets and development projects and that the funds be used promptly for authorized purposes only. Last September, the Internal Revenue Service issued temporary and proposed regulations under section 936 (d)(4). Before that, the Treasury Department and the IRS reviewed potential CBI investments submitted to us on a case-by-case basis. This was done in order to assist potential investors in the absence of published regulations, but such approval was not required.

During that period 12 cases were submitted to us for review. And of these, seven cases were approved. We believe that the 936/CBI program benefited from our review of specific transactions. And from the review process we were able to identify many problems associated with CBI investments and, as a result, we were able to provide more relevant and practical guidance in the regulations.

Some of the major issues that we faced included the use of 936 funds for refinancing existing facilities; the use of 936 funds for privatizing nationally owned businesses; the use of Federal guarantees for 936 funds; the arbitrage of 936 funds; the use of multiple financial intermediaries to make 936 loans; and the use of conduit investments.

The regulations generally allow the use of Federal guarantees for 936 loans, and if the obligor is located in a qualified CBI country, conduit investments. The regulations, however, provide that 936 funds may not be used to refinance existing facilities because refinancing does not generate appreciable new assets in a CBI country. In addition, the regulations limit the number of non-Puerto Rican financial intermediaries to one, so that the benefit of a reduced 936 interest rate accrues to the ultimate borrower and not to a series of intermediary institutions. Also, the regulations generally require that a borrower of 936 funds use the funds for authorized purposes within 6 months after obtaining the funds. This requirement was added in order to prevent arbitraging 936 funds; that is, investing the funds in obligations that yield higher interest than the interest the borrower owes on 936 funds. The regulations currently reserve on the issue of privatization, and we are working with the State Department, the Agency for International Development, and the Overseas Private Investment Corporation to develop appropriate definitions and procedures to cover privatization cases. We expect to complete this work in the near future.

You asked the Treasury to address whether the 936 program has been effective in promoting investment and employment in the CBI region and how the program could be improved to better achieve these goals.

Because 936 funds available for lending are private deposits in financial institutions and not public funds, the success of the 936/

CBI program must be evaluated in light of the commercial reality of the CBI market. Financial institutions have been reluctant to make section 936 loans for CBI projects due to the perceived risk involved in investments in the region, except when the institution can obtain a comprehensive guarantee providing commercial and political risk coverage. OPIC may provide such a guarantee. However, OPIC involvement is generally limited to transactions which do not have an adverse impact on the U. S. economy or jobs. Also the problem of a mismatch between potential lenders and borrowers' needs is more pronounced in the 936/CBI market than in the non-936 market. In particular, there is substantial volatility in the short-term corporate deposits on which section 936 lending is based. Therefore, while development projects require long-term financing, financial institutions have generally been reluctant to lend on such terms where they are not assured of a long-term deposit base.

These unavoidable commercial restraints have affected the 936/CBI program. And the program could be improved if a comprehensive guarantee mechanism existed for CBI investments. The legislative history of the 1986 act makes it clear that the 936/CBI program should operate without additional cost to the United States. It provides that funds for such programs should be made available from possessions corporations, the Government Development Bank funds, and grants by the government of Puerto Rico. We have been informed by Puerto Rican authorities that they recently created a public corporation called the Caribbean Basin Financing Authority which will make 936/CBI loans and provide guarantees for such loans. The future success of the 936/CBI program may depend on the Caribbean Basin Financing Authority's ability and willingness to provide appropriate guarantees.

The efforts of the last few years are just beginning to bear fruit. We now have more TIEA's in place now, and several projects are in development. In the next 2 years we will see whether the program will work as intended. I am hopeful that the economic circumstances in the CBI countries permitting, we will see positive results.

I thank you, Mr. Chairman and members of the subcommittee for the opportunity to testify on this issue, and I will be pleased to answer any questions that you may have at this time.

Chairman PICKLE. Thank you, Mr. Gideon.

We do have questions.

I am going to proceed first and yield to other members. I hope that during this first foray we will try to limit ourselves to the 5 minutes, but we will be able to come back if anybody wanted to ask additional questions. We will have a lot of questions of Mr. Gideon.

But thank you for your testimony.

Now, let me ask you first an overall kind of a question.

What commitment did Puerto Rico have with the United States regarding section 936 funds to CBI countries?

Mr. GIDEON. Basically to provide $100 million of those funds a year in CBI loans to other CBI countries.

Chairman PICKLE. More specifically, was there a commitment to make available and to actually loan out $100 million of these moneys?

Mr. GIDEON. I think to use, certainly to use their best efforts and good faith efforts to try. I think that they thought they could do that and I think you should ask the Puerto Rican witnesses——

Chairman PICKLE. Well, there is a general feeling, Mr. Secretary, that there was a definite commitment made on the part of Puerto Rico to make these funds available and to actually make it. Do you agree with that?

Mr. GIDEON. Well, I think that there has been an effort to meet that commitment, Mr. Chairman, and I think that, yes. It is true that at the time the companies involved and the Puerto Rican government made a commitment.

Chairman PICKLE. Well, there are a lot of rumors and a lot of data that we have studied that indicate that there was no question about the commitment being made. I wonder, in view of your statement that it was generally agreed that there was a commitment. I wonder if my committee would have your agreement and cooperation for subcommittee staff to review the files down in Treasury regarding this agreement?

[The following correspondence was provided to the subcommittee:]

COMMONWEALTH OF PUERTO RICO

OFFICE OF THE GOVERNOR
RAFAEL HERNANDEZ COLON

February 13, 1985

The Honorable James Baker
Secretary of the Treasury
Department of the Treasury
Washington, D. C.

Dear Mr. Secretary:

You inherited a proposal to repeal section 936 of the Internal Revenue Code and replace it with a temporary, partial and diminishing wage credit for Puerto Rico. I urge you to reject this dangerous experiment promptly and decisively, for it and its very pendency are as inimical to U. S. interests as they are to Puerto Rico.

Only two years have elapsed since section 936 was amended to eliminate perceived abuses. The final amendment was championed by the Treasury, the Government of Puerto Rico, and U. S. companies operating in the Commonwealth. Just prior to the enactment of this amendment, I am advised, President Reagan personally expressed misgivings about modifying section 936. It was the understanding of all parties directly involved in working out the language of the amendment that section 936 would not be revisited until there was an opportunity to assess the effectiveness of these changes in curbing the abuses they addressed and until there was full consultation with the Commonwealth. Investments were made and tax incentives granted by the Commonwealth of Puerto Rico in reliance upon this understanding, and there has not yet been the experience required to support a fair assessment of the amendment. Nor has the Commonwealth been consulted.

Repealing section 936 will not increase U.S. revenues because the 936 companies will avail themselves of the opportunity to defer, possibly indefinitely, recognition of foreign source income. Many will move their manufacturing operations immediately to foreign sites. Absent section 936, costs are lower there because such sites are not burdened with the U. S. minimum wage, the Jones Act, and other federal regulations.

The limited wage credit proposed by Treasury would not begin to overcome these significant cost differentials that the United States imposes on manufacturing operations in Puerto Rico. Some companies may remain in Puerto Rico, at least temporarily until they recoup larger sunk investments, but these firms will not pay additional U. S. taxes, either. Instead, they will be taxed by Puerto Rico and thereby earn foreign tax credits. As the Treasury Report recognizes, they, too, may defer indefinitely recognition of income earned in Puerto Rico.

In all likelihood, repeal of section 936 will add to the federal deficit as it will surely damage Puerto Rico. Unemployment here --currently 20%-- already is nearly three times higher than the U. S. mainland average. But it would reach truly crisis levels with the demise of section 936. Puerto Rico would require additional transfer payments from the federal Treasury. Migration will become a floodgate with thousands of Puerto Ricans who are unwilling to go back to a subsistence economy moving to the already congested job markets in mainland states in search of work. The net effect will be senseless human dislocation and suffering and an avoidable increased drain on the federal treasury.

Furthermore, the earnings of 936 companies also account for more than 41% of total commercial deposits in Puerto Rican banks. Repeal, therefore, could lead to bank failures and significant federal insurance payments.

The repeal of section 936 will cause unprecedented social and political unrest in Puerto Rico. It will also engender grave concern elsewhere in the Caribbean and in Central and Latin America where the infliction of such damage upon United States citizens will not go unnoticed by those who understand that they have even less of a claim to U. S. concern. This would prejudice in Puerto Rico and the Caribbean, the national security interests of the United States.

In one of my first decisions as Governor I directed that section 936 funds on deposit in the Puerto Rico Government Development Bank be used to assist the United States in securing its national security objectives in the region. For example, Puerto Rico may offer 100% financing of a Puerto Rican plant in return for a company's commitment to finance a second plant elsewhere in the Caribbean to manufacture components for the Puerto Rican facility. Repeal of section 936, of course, would deprive us of the resources we are prepared to devote to this concept that has been so well received throughout the Caribbean.

The Treasury proposal has had a chilling effect on new investment in Puerto Rico. The proposal must be promptly discarded so that its damaging effects upon our efforts to develop our economy and assist the Caribbean cease as promptly as possible.

I look forward to meeting with you to discuss this most critical matter.

Cordially,

Rafael Hernández-Colón
Governor

85-05553

COMMONWEALTH OF PUERTO RICO

OFFICE OF THE GOVERNOR
RAFAEL HERNANDEZ COLON

March 12, 1985

The Honorable James A. Baker, III
Secretary of the Treasury
Main Treasury, Room 3330
15th Street & Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Mr. Secretary:

The Commonwealth's enclosed Report on section 936 of the Internal Revenue Code explains why the proposal for its repeal would be a disaster for the United States and Puerto Rico:

1. The repeal of section 936 would not raise additional revenues. The tax reform study's billion dollar revenue estimates depend on the assumption that 936 companies would not use alternative means of sheltering their income. This assumption is unrealistic since the Treasury's tax reform plan would allow these companies to defer U.S. taxation of their profits for an indefinite period by reincorporating in jurisdictions outside the United States (including Puerto Rico). "The repeal of [section 936] would not result in a large gain to the U.S. Treasury..." to the extent 936 companies take advantage of this tax-saving opportunity. 1/

2. Repeal of section 936 would add to the federal deficit. Additional welfare benefits would have to be paid to laid off employees of section 936 firms as well as to employees terminated by companies that supply those firms with goods and services. Migration to the mainland would increase and add to the United States welfare burden. Puerto Rico's 3.2 million people are United States citizens and thus are free to join the 2 million Puerto Ricans already living on the mainland where welfare benefits are higher and there is no "cap" on the Treasury's responsibility for such payments.

1/ Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation (Fourth Report) (February 1983), page 127.

3. Section 936 is the essential tool for economic development in Puerto Rico. Thousands of jobs have been lost in the past decade because of the imposition of the federal minimum wage, substantial reductions in protective tariffs, and steep increases in energy and other costs. Section 936 has enabled Puerto Rico to replace many of these lost jobs with better ones in high technology companies. Consequently, Puerto Rico's unemployment, while high, increased at a much lesser rate during this difficult period than unemployment in the United States, Great Britain, or Japan. Puerto Rico's ability to continue attracting new investment depends entirely on the retention of section 936.

4. The proposed wage credit is not an adequate substitute for section 936. The cost of hiring the lowest paid manufacturing workers in Puerto Rico would still be over $2 an hour even after the credit, while plentiful labor is available in neighboring Caribbean countries for as little as 33 cents an hour.

5. It is not true that section 936 "costs" the United States more per worker -- $22,000 -- than the average compensation received per worker -- $14,210. A compelling case can be made that it "costs" the United States nothing to forego taxes on profits that would not exist but for section 936. Furthermore, after correcting for errors in the Treasury study assumptions, the so-called "cost" of section 936 turns out to be $10,726 per worker, at most, while the real benefits per worker amount to $48,885.

6. Treasury has no legitimate cause to revise the ground rules for taxing business investments in Puerto Rico to which it recently agreed. Section 936 was amended by the Tax Equity and Fiscal Responsibility Act of 1982 less than three years ago to correct perceived abuses in the allocation of income between section 936 companies and affiliated U.S. firms. These amendments, painstakingly negotiated by Treasury, the Government of Puerto Rico, and other interested parties, were supposed to stabilize the uncertain tax environment in Puerto Rico. Shortly after TEFRA was enacted, the Assistant Secretary of the Treasury (Tax Policy), wrote to Senator Robert Dole, Chairman of the Senate Finance Committee, that "it would be premature" to change the rules at least until Treasury had data from which to determine whether the TEFRA amendments were working. Such data are not yet available.

7. Repeal of section 936 would undermine the Administration's Caribbean policy and jeopardize vital security interests of the United States. The thrust of U.S. policy in the Caribbean, embodied in the President's Caribbean Basin Initiative ("CBI"), is to protect United States security interests by fostering a stable democratic region through economic development. Repeal of section 936 would have the contrary effect of jeopardizing a critically important naval base by destabilizing the most important democracy in the region. It also would prevent the Government of Puerto Rico from pursuing its announced goal of using the leverage of section 936 funds to encourage development of "twin plants" in Puerto Rico and CBI countries.

In view of the overwhelming arguments against repeal of section 936, and the serious damage that the very pendency of this proposal is currently inflicting on the United States and Puerto Rico, I urge you to announce promptly the withdrawal of that proposal from any tax reform plan that may be sponsored by the Treasury.

Sincerely yours,

Rafael Hernández Colón
Governor

RHC
Encl.

COMMONWEALTH OF PUERTO RICO

OFFICE OF THE GOVERNOR
RAFAEL HERNANDEZ COLON

April 9, 1985

The Honorable James A. Baker, III
Secretary of the Treasury
Main Treasury, Room 3330
15th Street & Pennsylvania Ave., N.W.
Washington, D.C. 20220

Dear Mr. Secretary:

I deeply appreciated the opportunity to meet with you regarding Section 936. Commonwealth officials also had a valuable follow-up meeting with Steven R. Lainoff, the International Tax Counsel of the Treasury, and members of his staff.

I was gratified to hear from you that Treasury does not intend to propose any change in the tax laws that would affect Puerto Rico adversely. We are agreed that tax incentives are necessary to induce business to invest in Puerto Rico. The question you posed is whether the operation of the existing incentive could be improved.

We believe that Section 936 is working well and extremely beneficially for Puerto Rico. According to a new Citibank economic study, the preliminary results of which only have become available this week, the Section 936 companies now account for 60 percent of manufacturing employment in Puerto Rico, 73 percent of gross domestic product in manufacturing, and 25 percent of total salaries paid in all sectors of the Puerto Rican economy. Employment in Section 936 companies since 1977 has grown at a faster rate than in trade, construction, agriculture, or public utilities. During this period, although overall employment in Puerto Rico grew only .8%, employment in the Section 936 companies increased nearly 2%, while the non-936 companies suffered a net loss of about 1.5%. Taking into account both increases in productivity and employment over this same period --1977-84 -- the Section 936 companies have achieved a faster growth than any other sector of the Puerto Rican economy. We must be very careful not to jeopardize this success, for any change in the tax laws that would decrease the incentive of these companies to remain in and expand their investments in Puerto Rico would have an enormous adverse impact on our economy, and, as we explained in our March 12, 1985 report to you, this damage to our economy inevitably would add to the United States deficit.

I reaffirm my commitment, expressed to you in our meeting of March 12th, that our Government will cooperate with Treasury to eliminate any abuses. From discussions with Mr. Lainoff, it appears that the principal concerns with Section 936 are its complexity and apprehension that there still may be the transfer to Puerto Rico of intangibles income which is properly attributable to the United States. As to the complexity point, I note that we are dealing with a limited number of sophisticated corporate taxpayers that accept the complexity of the provision as a fair trade off for its effectiveness as an incentive. On the question of intangibles income, Mr. Lainoff acknowledged that the recent TEFRA amendments to Section 936 addressed this problem and that the Treasury does not yet have sufficient data from which to draw any definitive conclusions about its success. I am sure you will agree that we should wait until this information on the results of the last major overhaul of the statute is available, carefully analyzed, and we are afforded an opportunity to comment upon these results before you conclude that the risks to Puerto Rico and the United States of revisiting this provision are fully warranted. If the data show that section 936--as amended-- is being used to shelter income that should properly be subject to tax, we will be happy to work out appropriate responses with you and your staff that will eliminate the abuses without destroying the Section 936 incentive on which our economy depends.

I do not believe that a wage credit--any wage credit--could replace Section 936 without doing immense harm to Puerto Rico. No wage credit legislation that realistically would have a chance of passage could overcome Puerto Rico's cost disadvantages relative to the countries with which it must compete. Most of these cost disadvantages are beyond Puerto Rico's control. For example, there is a huge disparity between the United States minimum wage imposed by law in Puerto Rico and the wages that prevail elsewhere in the Caribbean and Asia. In addition, Puerto Rico suffers from higher shipping, environmental, and other costs imposed by United States law.

Unlike Section 936, that has proven effective in generating the high technology, capital-intensive jobs to which Puerto Rico must now increasingly look, a wage credit approach would help only with those labor-intensive jobs that we can no longer sustain. At the same time, a wage credit is no less immune to economic criticism than Section 936. In fact, as the new Citibank Study reveals, the Section 936 sectors that are most efficient in generating secondary jobs are those that would receive the least benefit from any administrable wage credit. It is worth noting, for example, that the capital-intensive drug industry generates more total employment in Puerto Rico than the more labor-intensive apparel industry. These considerations are important because in the case of these two sectors, total employment is nearly the same and conclusions based solely on the criterion of direct employment are misleading and incorrect.

The Treasury recently testified in opposition to another wage credit, the Targeted Jobs Tax Credit, arguing that there is little evidence that it results in a significant number of additional jobs, while employers are rewarded for hiring workers they would have hired anyway. The real possibility that a Puerto Rican wage credit would eventually come under similar attack would make even a "permanent" wage credit of dubious value in attracting new jobs to Puerto Rico, particularly with companies who will remember that the Treasury called for repeal of Section 936 only a few short years after successfully sponsoring it in amended form in Congress.

There would also be administrative problems and abuses with the wage credit. Companies would have an incentive to hire employees that now work for independent firms that supply goods or services to 936 companies. This would enlarge the companies wage credit (and the tax loss to the Treasury) but would not expand Puerto Rican employment.

There is no need to risk Puerto Rico's economy by experimenting with questionable replacements for Section 936. If you will give us the chance, we can and will show you that Section 936 can be used imaginatively to achieve our common goals for Puerto Rico while, at the same time, serving as an important instrument to meet the President's goals of economic development and political stability for the entire Caribbean region.

The economic study I submitted to you last March referred to a plan announced in my inaugural address to use Section 936 funds to stimulate investments in "twin plants" in both Puerto Rico and a CBI (Caribbean Basin Initiative) country. Initially we will provide financing on favorable terms through Puerto Rico's Government Development Bank, based on its deposits of 936 earnings, for expansion of job-creating opportunities in Puerto Rico on condition that recipients utilize their own funds to invest in supplementary manufacturing facilities in Caribbean Basin Initiative beneficiary nations.

Already we have received a commitment from one company -- Johnson and Johnson -- to make an investment in Grenada in connection with the expansion of its facilities in Puerto Rico, provided that before it undertakes the additional investments required, it has reasonable assurance that the tax benefits of Section 936 will remain available to justify such expansion. I have been advised that these investment plans will go forward if the tax reform package that the Administration submits to Congress does not include any proposal to revise Section 936.

Three other companies -- SmithKline Beckman, Schering-Plough, and Abbott Laboratories -- are also seriously exploring projects that similarly involve new investments in both Puerto Rico and Grenada.

While none of these companies will make a positive investment decision absent an indication in the Administration's tax reform legislative proposal that it will not seek revision of Section 936, I am not content to await that decision. To advance all of these projects, this Friday, April 12, I will personally bring to Grenada representatives of these four companies for a meeting with Prime Minister Blaize and their first direct look at Grenada.

In addition to construction jobs, when it becomes operational the Johnson and Johnson project would produce 50 to 60 badly needed manufacturing and subsidiary jobs for that country, as well as new investment and jobs involving applied laser technology in Puerto Rico. If the other three companies that are all quite enthusiastic about this opportunity are able to finalize plans for operations of a similar scale, we could generate upwards of 200 new manufacturing jobs in Grenada utilizing the leverage of our 936 funds expended for new projects in Puerto Rico. We have moved rapidly in the just over three months that we have been in office. If you will leave in place the critical Section 936 tool we need to succeed in this effort, I promise you that in short order we will establish similar new employment throughout the Caribbean and Central America as well as in Puerto Rico. In fact, today I spoke personally with President Napoleón Duarte of El Salvador about our CBI initiative and he is enthusiastically awaiting a visit from our Secretary of State to meet with his cabinet and establish twin plant relationships with El Salvador based on new investments in Puerto Rico financed with Section 936 earnings. Last week I spoke with President Monge of Costa Rica and he, too, expressed his strong interest in, and support for, this form of economic cooperation.

We also intend to use incentives under the Puerto Rican tax system to encourage Section 936 companies to invest their cash in longer-term deposits that can be used to finance mortgage loans and revive our depressed construction industry. The Citibank economic study shows that 60 percent of 936 funds are invested in short-term deposits of 60 days or less, and 97 percent are invested for less than one year. We need to have more of these funds invested in 5-year or longer term notes so that we can provide more housing and create more jobs for the people of Puerto Rico. Once again, however, it is critical that the instability created by last November's proposal to repeal Section 936 be removed as quickly as possible. No matter what tax incentives we offer, Section 936 companies will not make long-term commitments to Puerto Rico or ancillary investments in the Caribbean Basin Initiative countries as long as they think they may have to leave in the near future because of a change in the tax laws.

Mr. Secretary, we ask you not to sanction an experiment that risks the welfare of the Puerto Rican people and risks our initiative that holds so much promise for the entire Caribbean Basin. On behalf of all of our people, I reiterate what Governor Ferré and I joined in urging -- that you affirm the commitment Treasury made to Puerto Rico after enactment of TEFRA -- that Section 936 will not be repealed or revisited until there is convincing proof of the need to do so and full consultation with the Government of Puerto Rico whose people are now so dependent upon this critical tool of economic development. If and when such proof is shown to us, we will do everything in our power to assist you in eliminating abuses and making Section 936 the most efficient and effective incentive possible for Puerto Rico.

Sincerely,

Rafael Hernández Colón

COMMONWEALTH OF PUERTO RICO

OFFICE OF THE GOVERNOR
RAFAEL HERNANDEZ COLON

September 3, 1985

HAND DELIVERED

The Honorable James A. Baker
Secretary of the Treasury
Main Treasury, Room 3330
15th Street and Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Mr. Secretary:

During our July 10, 1985, meeting, you and your colleagues expressed genuine interest in exploring Puerto Rico's twin plant initiative as an alternative to the Administration's tentative proposal to repeal section 936 of the Internal Revenue Code and to substitute a limited wage credit. What we offer is nothing less than an opportunity to create new Caribbean investment equal to the total U.S. investment in all the beneficiary nations of President Reagan's Caribbean Basin Initiative since the inception of that program.

We deeply appreciate your consideration of this alternative; we also understand your need for additional information. Immediately following our meeting, the Commonwealth retained the ICF firm to assist us in responding to two significant points that we discussed:

1. What is the true net fiscal cost to the United States Treasury of the current section 936 program? Put differently, leaving aside the fact that the Administration's proposal would produce no significant revenues during the first five years because of the proposed grandfathering transition provision, on a long-term basis what would the Treasury recover by repeal of section 936 and the substitution of a wage credit regime? How do these net costs compare with the current benefits of the program, without even taking account of our twin-plant initiative and other initiatives we have undertaken to make more effective use of the opportunities presented by the present section 936 program? We believe the answers to these questions provide a perspective that is essential to your assessment of the potential value of permitting our twin-plant initiative to go forward.

2. You asked us to provide more specific information on the twin-plant initiative and the commitments we have been able to garner in the relatively brief period since this effort was undertaken. This

request, in turn, was amplified in Secretary Pearlman's letter to me of August 19, 1985.

ICF has produced the enclosed reports which are responsive to each of these two points. I look forward to discussing both with you at our meeting on Friday, September 6, 1985.

As to the first point, ICF's best judgment is that repeal of section 936 and substitution of the wage credit proposed by the Administration would increase Treasury revenues by approximately $376 million per year -- significantly less than the approximately $1.7 billion of tax credits taken by section 936 corporations in 1982 which is sometimes used by Treasury officials as the measure of revenues expected from repeal of section 936. The enclosed report explains why the $1.7 billion figure is not an appropriate measure of the cost of section 936 to the Treasury even under the most conservative of reasonable assumptions. 1/ ICF further concludes, on the basis of very conservative assumptions, that the net benefits which inure to the people of Puerto Rico from the current 936 program,

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1/ ICF's calculations do not take into account the fact that no significant revenues can be anticipated during the five year transition period because of grandfathering.

without regard to the potential of our new twin-plant initiative and other initiatives undertaken by my Administration, are more than twice the net fiscal cost of section 936 to the United States Treasury.

The effectiveness of section 936 as the main support for the Puerto Rican economy cannot be over-emphasized. It is the compelling reason for maintaining the section without change. Conversely, the destabilizing effects on the Puerto Rican economy of the proposed change in section 936 are so pernicious as to stand conclusively on their own against the Treasury proposal. The twin-plant dimension which I will subsequently discuss is an important additional benefit of retaining 936 but not the fundamental consideration for maintaining the section without change.

With regard to the second point, the enclosed ICF report provides the comprehensive description of our twin-plant concept you have requested, including the corporate commitments obtained to date. In summary, our program consists of various efforts to encourage private companies to expand their present facilities in Puerto Rico or to make new investments in manufacturing facilities in Puerto Rico combined, in

either case, with complementary new investments in one or more Caribbean Basin Initiative countries. Such commitments to date could bring $72 million of new investment to the Caribbean and create 8,200 new jobs. Annually these projects would generate approximately $17.5 million in compensation to workers in the Caribbean. These commitments are from twenty-one significant section 936 corporations now prepared to participate in our program, provided there is no change in section 936. None of these commitments are conditioned upon financing of the Puerto Rican portion of any such new investments on concessionary terms from redeposits of section 936 earnings that are now in our Government Development Bank. It may make sense in some cases to provide such financing, however, and we are prepared to do so.

Financing under this program is not limited to Section 936 corporations or their affiliates. Such loans will be available to any firm meeting the requirements specified under the Bank's normal loan policies, but which is involved in a twin-plant project.

The program will include loans for industrial, commercial, and service facilities. Financing will be available for the purchase, construction, or

expansion of buildings; purchase of machinery and equipment; medium and long term working capital when such financing is not available from other credit sources; and for other purposes according to the merits and importance of each case.

The size of the Caribbean projects may vary considerably. We have placed no specific limitations on the size of loans. The first two loans made under this program were to local Puerto Rican non-936 companies for $600,000 and $1.3 million, respectively. 1/ It should be noted that according to the loan policy statement there must be an expansion both in Puerto Rico and in the Caribbean area.

This program has been discussed with the major commercial banks, and it will receive their support in terms of joint financings and other means of cooperation.

Under the CBI loan program, the Bank will provide financial assistance to an operation

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1/ The $600,000 loan will finance the recycling of plastic waste in Puerto Rico to produce a resin for use in manufacturing plastic product in the Dominican Republic. The $1.3 million loan will finance the finishing of shoes in Puerto Rico from plastic undersoles manufactured in the Dominican Republic.

established or to be established in Puerto Rico, which in turn will invest part of its own resources in a complementary operation located in a Caribbean Basin nation. The product of the loan will be disbursed to the Puerto Rican operation, which will utilize the funds according to the purposes approved by this Bank.

Financing under this program may likewise be granted for development of an integrated complementary operation located in Puerto Rico, but where the firm's main office is located in any of the designated CBI countries.

The loan would be structured to meet the financial needs of the Puerto Rican project. The Government Development Bank may require the guarantee of the parent firm abroad. The tangible collateral of the loan will be located in Puerto Rico.

Under this program interest rates will be lower than under the normal lending programs of the Government Development Bank. Initially we have provided for a fixed rate of 9-1/2 percent for 5 years, or a variable rate which would be adjusted every 3 months. Currently the variable rate would be around 7 percent. There will be no difference in interest rates charged

according to the size of the loan. 1/

The second major incentive under this special Caribbean Basin Initiative program involves liberalization of the loan to collateral requirements. The principal amount of a loan under the Caribbean Basin Initiative program may exceed the normal 70 percent of appraised value on real estate offered as collateral, and it may exceed the normal 50 percent of appraised value of machinery and equipment. Specific loan limits will be set according to the merits of each particular project.

Thirteen of the twenty-one committed section 936 companies have identified specific projects and provided information on investment levels, number of jobs created, and the particular Caribbean Basin Initiative country in which new investments would be made. Eight companies have given commitments to participate, but are not yet in a position to disclose such specific information about their projects. Other

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1/ The 936 funds currently on deposit with the Government Development Bank are invested, along with other resources of the Bank, in loans to government instrumentalities, municipalities, and private enterprises in Puerto Rico. As of May 31, 1985, the rate of return on government financings were approximately 9.7 percent and on the private loans the rate was 10.9 percent.

companies are actively exploring possible projects, and we expect additional commitments soon. One of the largest commitments -- Intel's commitment to invest $40 million and triple its employment levels in its Puerto Rican and Barbados plants creating an additional six thousand jobs -- is, understandably, dependent upon the return to normal business conditions in the electronic chip industry as well as the retention of section 936 without change.

According to a recently published United States Commerce Department study, during the first sixteen months of the President's Caribbean Basin Initiative, total U.S. investment in the Caribbean amounted to $208.46 million, creating an additional 35,891 jobs: If given the chance, our twin-plant initiative will make a significant additional contribution. The commitments we have obtained in a few short months would increase the amount of U.S. investment by 35 percent and boost employment in the Caribbean by an additional 23 percent.

Of special note, in response to my urging, a number of section 936 companies have expressed a willingness to bring investments and jobs to areas of the Eastern Caribbean, such as Grenada, that have been

largely untouched by the President's CBI. Since January of 1984, Grenada has received a total of six U.S. investments amounting to $1.22 million which created 118 jobs. Beginning with a visit in May of this year, when I personally brought representatives from four pharmaceutical companies to Grenada, we now have secured definite commitments for five projects in Grenada. Two additional companies that have committed to participate in our twin plant program are choosing between Grenada and one other country. Assuming that one of these two decides to invest in Grenada, these six projects would bring $4.2 million of investments to Grenada and would create 430 new jobs in Grenada.

In short, the President can more than triple United States investment and jobs created in Grenada since the inception of his Caribbean Basin Initiative simply by withdrawing his proposal to repeal section 936, affording us an opportunity to move forward with our effort to develop the economy of Puerto Rico and the Caribbean.

I discern from the questions you asked and the questions put forward by Secretary Pearlman that there are three fundamental issues of concern:

1. Is the magnitude of the commitments attainable under our twin plant program sufficient when

considered along with the other benefits for Puerto Rico to warrant leaving section 936 unchanged?

2. How certain is it that these commitments will be honored, and

3. What means of enforcement exist in the event the companies fail to honor their commitments?

I believe the information I have already supplied covers the first concern. You must appreciate that it takes time and considerable effort to develop corporate projects that will work in an area such as the Eastern Caribbean that has not attracted such projects to date. We have already secured commitments that are quite impressive when measured against the success to date of the Caribbean Basin Initiative. This is a fair criterion for evaluation, it seems to me, given the fact that, as documented in the ICF report, the current section 936 is already extremely cost beneficial without taking into account the additional benefits of the twin plant program, the now fully subscribed $220 million housing trust and other initiatives of my Administration. Likewise, the scale of these initial projects compares quite favorably with the initial corporate investments in Puerto Rico that have grown over time to become major industrial plants.

However, we are prepared to go further. If section 936 remains unchanged, I shall exercise my authority under Puerto Rican law to condition future grants of tax exemption in appropriate cases on additional commitments of the kind that have been voluntarily offered to date by the section 936 companies. Furthermore, if section 936 remains unchanged, in addition to the $700 million I have already pledged to make available for financing projects in Puerto Rico that are complemented by private investments in Caribbean Basin Initiative countries, I am prepared to exercise my authority under existing Puerto Rican law to require depository banks to deposit an additional 2 percent of their section 936 deposits into the Government Development Bank and to require the Government Development Bank to make available a corresponding amount of $140 million of non-936 funds on deposit in the Government Development Bank to finance investment outside of Puerto Rico, in Eastern Caribbean countries, where such investments can be shown to be of direct benefit to the economy of Puerto Rico. This, together with the commitments of the section 936 companies to date will equal the total United States investment that has been made in all the beneficiary nations of the

Caribbean since the inception of President Reagan's Caribbean Basin Initiative.

I believe that the companies will honor their commitments because they are sincere and because it is in their enlighted self-interest to do so. I do not believe that we need more government bureaucratic oversight of this private sector initiative.

However, if you believe it is necessary, I am prepared to enter into an Executive Agreement with the Treasury Department to pledge that Puerto Rico will stand behind these corporate commitments. In the then unlikely event they fail to materialize, we will work with the Treasury Department to devise appropriate measures to achieve this goal. It is clear that section 936 will always remain an attractive target for administrative and legislative scrutiny. Accordingly, if the President withdraws his proposal to change section 936 and Congress agrees in order to permit the twin plant initiative to become a reality, it is inconceivable to me that the section 936 companies would fail to honor their commitments.

I believe we have answered all of the questions raised in Secretary Pearlman's letter of August 19, 1985.

The choice before you is clear. If you insist on pressing for changes in section 936, you may or may not succeed in Congress, but you will at best delay and most likely destroy our twin plant initiative, dashing the promise it holds for Puerto Rico and the rest of the Caribbean. If you will work with us to preserve section 936, together we can double what has been achieved to date under President Reagan's Caribbean Initiative. The Administration loses nothing by giving us a chance to demonstrate what we can achieve in realizing our common goal of economic development in Puerto Rico and the rest of the Caribbean. If we fail -- and I assure you we can't and we won't -- you can always revisit this issue in a few years. Indeed, we would be most pleased if we could devise, together, a joint Task Force approach to monitoring the progress of this critically important initiative.

Sincerely,

Rafael Hernandez Colon
Governor

Enclosure
cc: Richard G. Darman
Ronald A. Pearlman
J. Roger Mentz

DRAFT
November 14, 1985

MEMORANDUM OF AGREEMENT BETWEEN THE GOVERNMENT OF THE UNITED STATES AND THE GOVERNMENT OF PUERTO RICO

I. INTRODUCTION.

Section 936 has been responsible for economic progress, creation of jobs, and improvement of job skills in Puerto Rico. With no additional investment or cost to the United States, Puerto Rico is prepared to assist the United States to achieve similar results throughout the Caribbean in fulfillment of the President's C.B.I., provided section 936 is preserved, unchanged.

II. LINKAGE.

A. Puerto Rico will guarantee $100 million of new private direct investment annually in CBI countries.

B. Methods by which Puerto Rico will raise new investment include:.

1. **The Economic Development Administration of Puerto Rico ("Fomento") will have further confirmed its authority to require, in appropriate cases, that future tax concessions in Puerto Rico be conditioned on development and execution of one or more direct investment projects of a specified magnitude in CBI countries or on contribution to a Fomento-administered CBI development fund. Further, Fomento can renegotiate existing tax concessions by offering extensions of such concessions, or increases in exemption rates, in exchange for CBI contributions.**

a. Where feasible, Fomento will set annual target contribution which must be met by company to preserve Puerto Rican tax exemption. This target may be tied to value of tax benefits received under section 936;

Note that tying contribution to section 936 tax credit claimed on return assists U.S. tax administration by discouraging companies from inflating Puerto Rico income and claiming excessive credit.

b. Fomento will encourage companies to make direct investments in their own CBI projects, although companies unable or unwilling to do so will be able to satisfy target goals by

making contributions to development fund. For example, companies could be given double credit for moneys expended on their own projects as an incentive to making direct investments.

c. Assuming section 936 credits claimed annually equal $2 billion per year, Puerto Rico can raise $60 million annually by requiring commitments totalling in the aggregate only 3 percent of section 936 credits claimed by companies in Puerto Rico.

2. **Utilize $114 million of commitments to CBI projects already made to Governor of Puerto Rico.**

a. Note that commitments are contingent on section 936 remaining unchanged.

3. **Use Government Development Bank ("GDB") funds to make twin plant loans.**

a. GDB loans funds for Puerto Rican development at concessionary rates in exchange for commitment from loan recipient to invest in CBI projects.

b. Puerto Rico banks must invest 10 percent of their section 936 funds in GDB obligations. There are approximately $7 billion of section 936 funds on deposit; 10 percent or $700 million is available for twin plant loans. If only 5 percent of that amount is loaned annually, and a matching amount is committed to CBI countries by loan recipients, $35 million will be added each year to CBI investment.

4. **Use increase in GDB funds to make direct CBI loans.**

a. Secretary of the Treasury could order Puerto Rico banks who hold section 936 funds to increase from 10 to 12 percent the percentage of section 936 funds which must be invested in the GDB.

b. GDB will make available, out of its unrestricted funds, an amount equal to the additional 2 percent increase specifically for loans to CBI projects which benefit Puerto Rico (for example, which create a market for Puerto Rican products or preserve or enhance a source of supply of raw materials).

c. Assuming $7 billion of section 936 deposits, a 2 percent increase in the amount depository banks are required to invest in the GDB would make an additional $140 million available for CBI investments on a revolving basis.

5. **A joint U.S.-Puerto Rico supervisory committee, including representatives of the State and Treasury Departments and the National Security Council, would oversee the $100 million annual CBI investment.**

a. One of the functions of the committee will be to determine that companies required by the terms of their tax concessions to invest in CBI projects have in fact done so on a permanent basis. Companies that the committee determines have not made good faith investments in CBI projects per their commitments would lose their Puerto Rican tax exemption.

b. Another function of the committee will be to determine those areas in which CBI investments would be especially desirable from the standpoint of U.S. foreign policy and national security objectives. Puerto Rico would grant special incentives for companies willing to invest in these areas.

C. The commitments of the United States to linkage are:

1. **Preserve section 936 unchanged.**

2. **Cooperate with Puerto Rico in making best use of additional investments, e.g., by providing AID loans to improve infrastructure of developing economies; roads, port facilities, energy and water needs, etc.**

SEC 1. AMENDMENTS TO THE PUERTO RICO INDUSTRIAL INCENTIVE ACT OF 1978
(Title 13, Laws of Puerto Rico Annotated)

(a) Subsection (e) of section 255i(e) is amended by redesignating paragraphs (3) and (4) as paragraphs (4) and (5), respectively, and inserting after paragraph (2) the following new paragraph:

"(3) The Governor shall include in the tax exemption concessions terms and conditions establishing minimum required investments in one or more beneficiary countries, unless in his judgment such terms and conditions are not consistent with the purpose and provisions of this subchapter, or do not promote the economic and social development of the People of Puerto Rico."

(b) Section 255a is amended by redesignating subsection (r) as subsection (s), and inserting after subsection (q) the following new subsection:

"(r) Beneficiary Country.- For purposes of this title, the term "beneficiary country" has the meaning given to such term by section 212(a)(1)(A) of the Caribbean Basin Economic Recovery Act, Title 19 United States Code Annotated Section 2702(a)(1)(A).

EXHIBIT A

EXECUTIVE ORDER

WHEREAS, the Industrial Incentive Act of 1978 authorizes the Governor of Puerto Rico to issue tax exemption concessions to certain manufacturing and other businesses; and

WHEREAS, section 255i of said Act provides that the Governor may include in the tax exemption concessions such terms and conditions as are consistent with the purpose and provisions of the Act, and that in his judgment promote the economic and social development of the People of Puerto Rico; and

WHEREAS, the economic development of Puerto Rico has been made possible in part by tax incentives offered by the Government of the United States, principally in section 936 of the Internal Revenue Code of the United States, and by tax concessions offered by the Government of Puerto Rico; and

WHEREAS, in the judgment of the Governor, the preservation of section 936 can best be assured by linking enjoyment of tax benefits in Puerto Rico to investments in beneficiary countries named in the United States' Caribbean Basin Initiative ("CBI") program; and

WHEREAS, investment in beneficiary countries also enhances the economic and social development of the People of Puerto Rico by creating new markets for the products of Puerto Rico and new sources of raw materials for Puerto Rican factories, and by fostering stability and security in the entire Caribbean region;

NOW THEREFORE, by virtue of the authority vested in me by the Industrial Incentive Act of 1978, it is ordered as follows:

SECTION 1. New Tax Exemptions. From and after the date of this Order, all tax exemptions granted to manufacturing businessess shall include as part of the terms and conditions of their tax exemption concessions a paragraph substantially similar to the paragraph entitled "AGREEMENT TO INVEST IN BENEFICIARY COUNTRIES" as set forth in section 3 of this Order, unless the Governor in his judgment determines that the inclusion

of such paragraph is not consistent with the purpose and provisions of this subchapter, or does not promote the economic and social development of the People of Puerto Rico.

SECTION 2. Existing Tax Exemptions. The Administrator of the Economic Development Administration is hereby authorized to grant applications for the extension of existing tax exemptions for a period of up to ten (10) years, or to raise the exemption percentage of an existing tax concession by not more than five (5) percent, provided that the applicant agrees in exchange therefor to include as part of the terms and conditions of its tax exemption concession a paragraph substantially similar to the paragraph entitled "AGREEMENT TO INVEST IN BENEFICIARY COUNTRIES" as set forth in section 3 of this Order.

SECTION 3. Agreement to Invest in Beneficiary Countries. The following paragraph, or provisions substantially similar thereto, shall be included in the tax exemption concessions referred to in sections 1 and 2 of this Order:

"AGREEMENT TO INVEST IN BENEFICIARY COUNTRIES.

(a) The [exempted business] agrees that it, or any related person on its behalf, will make a qualified investment, or a qualified fund contribution, or both, each year during which this exemption remains in effect, provided that the sum of two times the amount expended as a qualified investment and the amount expended as a qualified fund contribution in each year shall be equal to or greater than __ percent of the credit against United States income tax liability claimed by the [exempted business] in the preceding year under section 936 of the Internal Revenue Code of the United States.

(b)(1) For purposes of this paragraph, the term "qualified investment" means an investment in -

(i) tangible property used or intended for use as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services in a trade or business conducted in Puerto Rico or one or more beneficiary countries, or

(ii) production costs (other than the cost of direct materials not produced in substantial part in Puerto Rico or one or more beneficiary countries) incurred with respect to a product manufactured or type of service rendered in Puerto Rico or one or more beneficiary countries,

provided that not more than _____ percent of investment which is considered "qualified investment" in any year shall be expended for property or for production costs used or incurred in Puerto Rico.

(2) For purposes of this paragraph, the term "qualified fund contribution" means a contribution to a fund administered by the Commonwealth of Puerto Rico or any agency thereof for the purpose of making or loaning funds for qualified investments.

(3) For purposes of this paragraph, the term "beneficiary countries" has the meaning given to such term by section 212(a)(1)(A) of the Caribbean Basin Economic Recovery Act.

(4) The Administrator of the Economic Development Administration is hereby authorized to establish the level of investment required for each applicant pursuant to this paragraph in accordance with the purpose and provisions of this subchapter.

EXHIBIT B

COMMONWEALTH OF PUERTO RICO

DEPARTMENT OF THE TREASURY

REGULATION

TO AMEND ARTICLE 10(a) OF REGULATION NO. 3087, APPROVED ON APRIL 17, 1984.

Section 1. Paragraph (2) of Article 10(a) of Regulation No. 3087, issued on April 17, 1984, under the authority of the various Puerto Rico Industrial Incentive Acts, Acts. No. 6 of December 15, 1953, 57 of June 13, 1963, and 26 of June 2, 1978, as amended, is hereby amended to read as follows:

"Article 10. Investment Requirement.

(a) The eligible depository institution shall at all times comply with the following investment requirements:

(1) . . .

(2) Own and hold at all times not less than twelve percent (12%) of the daily monthly average of its total eligible deposits, as herein defined, in obligations of the GDB. The return of these obligations shall be agreed upon by the GDB and the eligible depository institution according to the financial policies of the GDB. Eligible funds received through deposits or repurchase agreements for a term of five (5) years or more shall not be subject to this investment requirement.

(3) . . ."

Section 2. All other provisions of Article 10 and all other Articles of Regulation No. 3087 shall remain unchanged and in effect.

Section 3. These amendments shall become effective immediately after their approval, inasmuch as pursuant to the provisions of Section 11 of Act No. 112, approved on June 30, 1957, known as the "Rules and Regulations Act of 1958", the Honorable Governor of the Commonwealth of Puerto Rico has dispensed with their immediate filing with and publication by the Office of the Secretary of State of Puerto Rico.

San Juan, Puerto Rico, approved on November , 1985.

SECRETARY OF THE TREASURY

APPROVED:

RAFAEL HERNANDEZ COLON
GOVERNOR OF THE COMMONWEALTH OF PUERTO RICO

I ATTEST:

SECRETARY OF STATE

EXHIBIT C

EXECUTIVE ORDER

WHEREAS, by regulation issued on the same date hereof, the Secretary of the Treasury has amended Regulation No. 3087 to increase from ten percent (10%) to twelve percent (12%) the percentage of the daily monthly average of total eligible deposits that eligible depository institutions (as these terms are defined in Regulation No. 3087) are required to invest in obligations of the Government Development Bank;

WHEREAS, such an increase in the amount of funds invested in obligations of the Government Development Bank will free an equal amount of funds held by the Government Development Bank, which can be invested in beneficiary countries named in the United States' Caribbean Basin Initiative ("CBI") program;

WHEREAS, in the judgment of the Governor, the making of such investments by the Government Development Bank will contribute to the preservation of the tax incentives offered by the Government of the United States, primarily in Section 936 of the United States Internal Revenue Code, which tax incentives have significantly contributed to the economic and social development of the People of Puerto Rico;

NOW, THEREFORE, by virtue of the authority vested in me by Chapter 61 of Title 7, laws of Puerto Rico Annotated, it is ordered as follows:

SECTION 1. The Government Development Bank shall at all times make available, solely for the financing of eligible projects, unrestricted funds in an amount not less than two percent (2%) of the aggregate daily monthly average of the total eligible deposits of all eligible depository institutions.

SECTION 2. For the purposes of this Executive Order:

(a) "Eligible Deposits" and "Eligible Depository Institution" shall have the meaning specified in Article 4 of Regulation No. 3087, as may be amended from time to time.

(b) "Eligible Project" shall mean any project that (i) consists in the investment of funds in one or more CBI countries or in the Commonwealth of Puerto

Rico and one or more CBI countries and (ii) is determined by the Secretary of the Treasury to be in the best interests of the People of Puerto Rico.

(c) "Unrestricted Funds" shall mean funds other than those received by the Government Development Bank for the purchase by eligible depository institutions of obligations of the Government Development Bank pursuant to the investment requirements established by Article 10 of Regulation No. 3087, as may be amended from time to time.

(d) "CBI countries" shall have the same meaning as "beneficiary countries" as defined in section 212(a)(1)(A) of the Caribbean Basin Economic Recovery Act.

SECTION 3. This Executive Order shall become effective immediately after its approval.

San Juan, Puerto Rico, approved on November , 1985.

RAFAEL HERNANDEZ COLON
GOVERNOR OF THE
COMMONWEALTH OF PUERTO
RICO

I ATTEST:

SECRETARY OF STATE

cc: Wentz, Lainoff

COMMONWEALTH OF PUERTO RICO

OFFICE OF THE GOVERNOR
SAN JUAN, PUERTO RICO 00901

Puerto Rico
936 file

November 27, 1985

HAND DELIVERED

Mr. Richard G. Darman
Deputy Secretary
Department of the Treasury
Room 3326
15th and Pennsylvania Avenue, N.W.
Washington, D.C.

Dear Dick:

On behalf of the people of Puerto Rico, I want you to know how grateful we are for your personal efforts to support and preserve section 936 of the Internal Revenue Code. I especially appreciate what you personally achieved in the House Ways and Means Committee in furtherance of our twin plant program and your confirming to Bob Dee and to me during the course of our telephone conversation Friday morning, November 22, 1985, that:

1. The Treasury Department fully supports, without reservation, the determination to preserve section 936 that was agreed to by the House Ways and Means Committee on Saturday, November 16, 1985;

2. The Treasury Department will not seek to change in the Senate the decisions on section 936 made by the House Ways and Means Committee; and

3. In the Administration's view our plan for stimulating new private investment in Puerto Rico and beneficiary countries of President Reagan's Caribbean Basin Initiative was a critical factor in the Administration's commitment, expressed by Vice President Bush on Wednesday, November 20, 1985, to work with Congress to preserve into the future -- as a permanent supplement to the President's Caribbean Basin Initiative -- the benefits of section 936.

I would very much appreciate it if you would confirm these points in a letter to me. I believe that such written confirmation from the Treasury Department will be of enormous assistance to the Commonwealth of Puerto Rico's effort to move forward promptly with our program for the Caribbean.

Warmest personal regards.

Sincerely,

Rafael Hernandez Colón
Governor

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

December 3, 1985

Dear Governor Colon:

Thank you for your letter of November 27, 1985 in which you summarize your understanding of our November 22 telephone conversation.

I am happy to confirm hereby all three points of your summary, subject only to this understanding: Our decision to "preserve section 936" was based on its being modified as in the attached Ways and Means Committee description of the "Compromise proposal." As you know, that compromise includes constructive reforms of section 936 and other provisions, and also looks forward to -- indeed implicitly depends upon -- the effective implementation of your "twin-plant" initiative.

I am especially pleased that a satisfactory compromise has been achieved -- one that can command the support of Puerto Rico, the Administration, the Congress, and the concerned representatives of industry. It is the breadth of such support -- which we understand all parties intend to maintain throughout the legislative process -- that I hope and believe can provide a more stable basis for further investment in Puerto Rico and the Caribbean Basin.

Please let me know if there are other ways in which we might help.

With best regards,

Richard G. Darman

Honorable Rafael Hernandez Colon
Governor of the Commonwealth of Puerto Rico
San Juan, Puerto Rico 00901

Attachment: Ways & Means "Compromise proposal"
BCC: Ronald A. Pearlman
Michael K. Deaver
Richard D. Copaken

POSSESSION TAX CREDIT

Compromise proposal

1. Retain cost-sharing option for allocating intangible income.

2. Retain posession tax credit for 100-percent of qualified possession-source investment income (i.e., no 50-percent reduction).

3. Allow qualified possession source investment income to be invested in active business assets located in qualified Caribbean Basin Initiative countries. This would allow the Government of Puerto Rico to fully implement the proposed "twin-plant" initiative. To qualify a CBI country would have to enter into an exchange of information agreement with the Treasury. In addition, as provided in regulations, certification would be required that investments in such countries were for active business assets. The twin-plant initiative would be subject to committee supervision and review to ensure that significant employment-producing investment in qualified CBI countries materializes.

4. Repeal section 936(b) which denies the credit with respect to otherwise eligible income if receipt of income occurs outside of the possessions.

5. Increase from 65 percent to 75 percent the portion of possession corporation income required to be derived from the conduct of an active trade or business. Under a transition rule, 70 percent requirement would be effective for tax years beginning in 1986 and 75 percent requirment would be effective for tax years beginning in 1987.

6. Under the cost-sharing option, require that cost-sharing payments be equal to the greater of: (1) the present law cost-sharing payment increased by 10 percent and (2) the royalty payment that would be required (under sec. 367(d) or sec. 482 of the Code) if the possession corporation were a foreign subsidiary of the U.S. parent corporation. As under present law, the cost sharing payment would continue to be U.S. source income. In addition, amend section 367(d) and section 482 in connection with the transfer of intangibles from a U.S. corporation to a related foreign corporation. Royalty payments with respect to intangibles sold, contributed to capital, or licensed would be required to be commensurate with the actual annual income stream attributable to the intangible.

7. Authorize the Commissioner to require the submission, with the tax return, of information relevant to section 936 tax computations.

Revenue Estimate

Estimated revenue loss of $0.7 billion from Ways and Means option.

Mr. GIDEON. Well, certainly. I mean as we have indicated to your staff, Mr. Pickle, we would be happy to share under the appropriate 6103 protections any specifics that you would like to see.

Chairman PICKLE. I think we will be working with you on that review.

Now, for the broad question; has Puerto Rico lived up to its commitment?

Mr. GIDEON. Well, in terms of the amount of funds lent, they are a little short. In terms of effort to implement the commitment, I think there has been an effort to implement the commitment.

Chairman PICKLE. Well, let me refer you. Back in 1985, when Treasury was pushing to replace 936 with a wage credit, the Ways and Means Committee, according to our committee report, decided to make "relatively minor modifications" to section 936 because we were "motivated in large part by the representation by the government of Puerto Rico that it intends to vigorously pursue the twin-plant initiative outlined in the memorandum of agreement."

Has Puerto Rico vigorously pursued that initiative?

Mr. GIDEON. I think that they have made real efforts, Mr. Chairman. On the other hand, I think the numbers speak for themselves.

Chairman PICKLE. Well, when you say the numbers will speak for themselves, they made three loans of $70 million in 3 year's time. Mr. Secretary, is that vigorously pursuing it?

Mr. GIDEON. I think there, as I told you, we actually reviewed 12 projects of which 7 were approved by us and then ultimately others were funded. We did not see all of them because they were not required to come to us with all of them.

Chairman PICKLE. Mr. Secretary, there may be reason to understand why, but you cannot say that they have vigorously pursued this in a successful way when they have actually loaned only $70 million in 3 year's time.

Now, I do not think that we need to go into that further, but I do want to ask you some specific questions about some of these operations.

What is the annual revenue loss attributable to 936 funds?

Mr. GIDEON. We estimate that for this fiscal year it will be about $2 billion.

Chairman PICKLE. About $2 billion. All right now, how does this revenue loss compare to the amount of compensation paid to Puerto Rican workers? In other words, what is the revenue loss as a result of section 936 for every $100 paid to a worker in Puerto Rico?

Mr. GIDEON. Well, the last period for which I can give a fairly confident answer to that question is 1983, which was covered in the sixth report that we issued last year. At that time, the revenue loss exceeded the wages paid and I think it would be our surmise that is probably still the case.

Chairman PICKLE. Well, let me review it for you, Mr. Secretary. According to records and charts that we have studied, for every $100 of wages paid, 936 corporation realized $125 in tax benefits. That is on the average. And on the average, for every $100 we lose $125.

Mr. GIDEON. I would not have the basis for disagreeing with that, Mr. Pickle. Although as I point out, I do not have the most current data.

Chairman PICKLE. Well, I do have in front of me. So let me proceed.

What industries receive the greatest tax benefit from every dollar paid out to employee compensation?

Mr. GIDEON. According to our report that we issued last year, the pharmaceutical industry.

Chairman PICKLE. Do you know what amount that is?

Mr. GIDEON. Well, basically just looking at table 4-6 from our report, in which we calculated tax benefits as a percentage of employee compensation we reported at that time that approximately 265 percent is the——

Chairman PICKLE. I did not hear you.

Mr. GIDEON. 265 percent was the tax benefit to compensation.

Chairman PICKLE. For the pharmaceuticals for every $100 paid in wages, they get $265 in tax benefits, is that correct?

Mr. GIDEON. That would be the import of that.

Chairman PICKLE. How many corporations claimed the 936 credit?

Mr. GIDEON. This number has varied from time-to-time. It has typically been around 600. Most of the revenue though is associated with a group of about 100 to 200.

Chairman PICKLE. Well, my records show that over 625 of them actually use this in some way or another.

Now, what industry gets the lion's share of these funds?

Mr. GIDEON. Well, again, in terms of just the volume of these things, it would be pharmaceuticals.

Chairman PICKLE. Yes, the pharmaceuticals get about 46 percent of the funds of the 936 program.

What is the average salary in the pharmaceutical industry?

Mr. GIDEON. I do not have that data right in front of me, Mr. Pickle, although we can get it for you. I think we had some in the 86 report.

We showed again in our report that the average salary was $13,149.

Chairman PICKLE. Thirteen?

Mr. GIDEON. $13,149.

Chairman PICKLE. Well, my chart shows that the average salary in the pharmaceutical industry was $21,000.

Mr. GIDEON. Oh, I am sorry. It is, yes, I see the column you are referring to. This is the average employee compensation column.

Chairman PICKLE. And there are some industries then which actually get less than a dollar in tax benefits. For instance, the apparel industry they only get about 32 cents by comparison to the 265 for the pharmaceutical.

So it has a great variance, does it not?

Mr. GIDEON. Yes, it is very variable.

Chairman PICKLE. All right, now, let me skip on to one or two other questions and then I will yield to Mr. Schulze.

I guess before we go off this subject, let me ask you, would a wage credit be a more efficient way of promoting jobs in Puerto Rico?

Mr. GIDEON. I think that, as you noted, the Treasury Department at an earlier time had recommended a wage credit to the Congress, but that issue was definitively debated in 1986, and we do not propose to revisit it at this time.

Chairman PICKLE. Well, I am trying to understand your answer. You said you did propose it, but this is 1990 and you do not propose to revisit it. In other words, you are not proposing a new approach at this point?

Mr. GIDEON. Not today.

Chairman PICKLE. Not today.

If you had a wage credit, would that not even things out?

Mr. GIDEON. Well, I think that the benefits of a wage credit are pretty obvious, as was stated at that time. On the other hand—and it would certainly even things out among these industries.

Chairman PICKLE. All right.

Now, I want to get into one other subject and leave that credit for some of the other members' questions.

I think I want you to tell me a little bit about five projects which the Treasury issued no objections—in other words, you approved all of them in effect—regarding the use of section 936 funding. And there are the Air Jamaica loan of $51 million; the AT&T trans-Caribbean cable loan of $17 million; the ABC container factory loan of $2.1 million; the Spanish Port Free Zone in Jamaica—even though that is not yet funded—and then the loan to Cable and Wireless for purchase of Barbados telephone. Can you comment on that?

Mr. GIDEON. I cannot in open session, Mr. Pickle, because of 6103 restrictions. We would be happy to provide your staff with details under appropriate 6103 protections.

Chairman PICKLE. Well, I do not quite understand. I want to accept what you are saying, but I just do not understand it. Say it again for me.

Mr. GIDEON. All I am saying is that we cannot comment on specific tax payer projects within the confidentiality restrictions but we will provide that data under appropriate protections, under the procedures that we have with the committee.

Chairman PICKLE. All right.

Well, did Treasury ever approve a loan to the UDC Trans-Shore involving the use of 936 funds for prefabricated housing in Jamaica?

Mr. GIDEON. Again, Mr. Pickle, I cannot comment in this session on specific transactions.

Chairman PICKLE. Well, did you ever issue a no objection to that?

Mr. GIDEON. Mr. Pickle, I have the same problem that I have had in responding to the last couple of questions.

Chairman PICKLE. Well, was that project ever submitted to you, Treasury, do you know?

Mr. GIDEON. I would have to consult those specific records, but I think the point again is that I would not be able to reply as to specifics here, in open session.

Chairman PICKLE. Well, I am going to yield my time, at this point, to Mr. Schulze. I have other questions but I want to—I will come back to you, Mr. Secretary.

Thank you.

Mr. SCHULZE. Thank you, Mr. Chairman.

Ken, I want to broaden the discussion for a second or two. It seems to me what we are doing with 936 funds is giving this reservoir of revenue to the government, to the people, to the institutions in Puerto Rico to try to create economic activity.

I understand that it is about 40 percent of the assets of the banking community in Puerto Rico. So it is in effect, saying in relationship to the other 60 percent, we are going to give you an amount of money that would be equal to about 80 percent of your assets.

That is going to relieve a lot of pressure on loans. It should give you a very viable, vibrant, dynamic banking structure. It seems to me, and I am getting to my question, that with that type of asset Puerto Rico should be the financial center of the Caribbean. It just seems to me that an opportunity is there and has been, in my opinion, totally missed by Puerto Rico.

I wanted to have your opinion on that.

Mr. GIDEON. Well, I would not consider myself an expert on Caribbean banking relations, Mr. Schulze. Although I would simply say that I think that it is clear that these funds are an important source of funding for the Puerto Rican banking system.

Mr. SCHULZE. Well, I think if we offered that same deal to Florida, that the banks in Miami would take such advantage of that they would virtually dominate not only Central and South American and the Caribbean but probably the Southeastern United States with that type of an asset.

I am just afraid that the ball has been dropped in my opinion. An asset has been given, an opportunity has presented itself which has not been utilized. I say this in light of looking not only at 936 funds, because that is not the total assets of the financial institutions in Puerto Rico but that other amounts of money, which have been freed up for utilization, which has not been used to help develop the Caribbean Basin. In a fairly parochial way, Puerto Rico has said, we are not going to do anything that creates competition for us. I can understand that, but I think it is totally wrong in this instance. I believe that we should look at the broader picture and not just 936 in this context.

Maybe you can answer one question for me. Do you have any idea of the potential for borrowing needs throughout the Caribbean? In other words, we are saying there have been only a few loans made here, I would think the potential is just astronomical.

Mr. GIDEON. Oh, I think the need for capital is obvious. I think as I noted in my testimony, though, the ability of the system to provide adequate guarantees to induce commercial lenders to make those loans is another question.

Mr. SCHULZE. Where else should this money come from? It just seems to me to be natural for Puerto Rico to be the instrument to use this large financial asset in some manner to try to create these economic activities.

Mr. GIDEON. Certainly that is the hope of the 936 (d)(4) program.

Mr. SCHULZE. All right.

With that in mind, I have to say that I believe that Puerto Rico has not really lived up to its pledge or its promise to try to do this. As I said a minute ago, I can understand somewhat their reluctance because they view this as building up competition. Somebody is going to go out there and they are going to work harder or they

are going to sell a product for less or they are going to create economic problems for us.

But I am afraid I also view that as extremely short sighted and that attitude is probably going to have to change. I believe when we discussed this in 1986, I made the statement that any State of the Union would love to have $10 billion and probably most of them, if we offered them a $10 billion asset, would say I will loan out $1 billion of that at below market rates and even for risky loans around the area. Any of them would be happy to do that. I just have not seen that enthusiasm from Puerto Rico to try to make this structure work.

In line, Ken, with the questions that the chairman was asking, you stated in your testimony that the Treasury Department is not required to approve every 936 loan on a case-by-case basis. But even if Treasury approval is not required, will not most lenders apply for comfort rulings so that they are somewhat secure in their position?

Mr. GIDEON. Well, I think now that the regulations are out that may not be so, Mr. Schulze. I think before that, that was probably true, at least for major projects. But the purpose of giving regulatory guidance was to allow people to proceed directly.

Mr. SCHULZE. Why did the 936 regulations limit Caribbean investments to loans and not allow equity type ventures?

Mr. GIDEON. Well, that was our understanding of the purpose. If that is an incorrect understanding then obviously this committee could give us guidance.

Mr. SCHULZE. I, for one, would certainly favor that type of broadening.

Will you give us your opinion on using 936 funds for privatization transactions, the purchase of assets previously owned by government, by private parties?

Mr. GIDEON. That is certainly a permitted purpose. The difficulty has been really in working out an adequate set of working definitions. And we have, as I noted in my testimony, had a lot of conversation with the appropriate international development agencies to try to come up with general guidance that we could publish in the form of regulations.

Mr. SCHULZE. Why did the regs limit 936 loans to finance no more than 10 percent working capital inventory?

Mr. GIDEON. Oh, again, our thought was that this was to provide new development. In other words, as we understood the purpose of the statute and not to provide straight forward working capital loans.

In other words, it really was project development oriented.

Mr. SCHULZE. Thank you, Ken.

Thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Schulze.

Mr. Anthony.

Mr. ANTHONY. Ken, are you permitted under protection section 6103 to go into the Air Jamaica transaction at this hearing?

Mr. GIDEON. Not in open session, Mr. Anthony, but as I have indicated, we will be happy to answer specific questions through the appropriate mechanism to the committee.

Mr. ANTHONY. Have you read the——

Chairman PICKLE. Mr. Anthony, will you yield just a minute?

Mr. ANTHONY. Certainly.

Chairman PICKLE. Mr. Gideon, not just with respect to Air Jamaica, but all these loans, the previous one to UDC, you had reservations and you could not talk about it. I would like for you to ask for a waiver of these individual taxpayers so that we can discuss this at the next hearing. I am going to ask these questions of some of the people—the witnesses coming-up and I would like for you to be able to talk about them too at the next hearing.

Thank you, Mr. Anthony.

Mr. ANTHONY. Ken, are you familiar with the October 2, 1989 article in the Commercial Aviation Report concerning the use of section 936 funding to close the Air Jamaica A-300 leases?

Mr. GIDEON. I am not familiar with the article, Mr. Anthony.

Mr. ANTHONY. Would the staff give Ken a copy of the article? What I would like to do then is to proceed with the questioning about the going through your records, since you are protected under commercial aviation reports that are reported in the article.

They have a very lengthy article about the transaction and I guess what I would like to find out from you, if I discuss something that was publicly disclosed would Treasury still take the position that they were not permitted to confirm or deny the statements contained in that article?

Would you still be under that restriction of 6103?

Mr. GIDEON. To the extent that it relates to information we gained through confidential processes, yes.

Mr. ANTHONY. Let me just then ask you a series of questions and if you can respond to them, do, and if you have to respond in a confidential letter or memo for the record, so be it.

In your testimony you said that those projects that went forward obviously within the mandate or obviously that were consistent with the rewrite under section 936 were done in a very short period of time.

The article indicates that the funding for Air Jamaica went over a year. Could I take it then that by that reasoning in your testimony that this one was inconsistent with what we attempted to do when we rewrote 936?

Mr. GIDEON. I really do not feel comfortable discussing a specific case here, in open session.

Mr. ANTHONY. OK, well, then let me just make a few——

Mr. GIDEON. But I would be happy to take——

Mr. ANTHONY. I understand the problem you have, Mr. Gideon.

Mr. Chairman, if you would bear with me then, I would just like to make a couple of comments about Air Jamaica. We are taking U.S. taxpayers' money in hopes of trying to help Puerto Rico and then rather than taking it back through a wage credit that was proposed by Treasury, we adopted the twin-plant concept. What disturbs me is that according to the October 2, 1989 Commercial Aviation Report, the airplanes that were purchased were not even American made airplanes. These were airplanes that were made by foreign competitors and purchased from Brazil.

I just have a real problem with that. I would hope that some place in your discussions that the Secretary of Commerce propose a very strong objection to it. I could only presuppose that the Secre-

tary of State and Secretary of Treasury probably overrode Secretary of Commerce's objections. But, I, for one, would be taking a close look at future transactions when you got U.S. tax dollars going and buying foreign products.

Chairman PICKLE. Would the gentleman yield?

Mr. ANTHONY. Yes, of course.

Chairman PICKLE. We have statements from people in the Treasury who said that the State Department exercised substantial pressure in that Air Jamaica loan. Would you comment on that statement that we have received?

Mr. GIDEON. I really could not comment on that, Mr. Pickle. Again,——

Chairman PICKLE. We will hear more about that later.

Thank you.

Mr. ANTHONY. Ken, I understand the dilemma that you are in but we need to try to get as much out on the public record as is permissible.

What I would like to do is to point back to your testimony on page 4, line 7 and you state that FOMENTO, the Puerto Rican government agency to promote 936 funds would approve a 936 loan if the transaction did not have a negative impact on Puerto Rico.

They obviously signed off on the Air Jamaica deal so that they did not think that it had a negative impact there. But I have gone back and have reviewed both the Ways and Means Committee report and I have reviewed the Senate Committee report, and conference report trying to track down some legislative history on 936 and the rewrite under the twin-plant concept.

I cannot find anything in the report language or in the statute that would indicate that this was anything that Congress imposed in terms of a limitation. I just wondered if you have any recollection or if you have any information which you could share with me about where this particular impediment would come from?

Mr. GIDEON. In other words the Puerto Rican——

Mr. ANTHONY. Yes.

Mr. GIDEON. I do not believe that there is anything in the legislative history that supports that, Mr. Anthony.

Mr. ANTHONY. Yet, you obviously are sensitive to it, because you are now adopting it as one of your criteria, at least you adopted it as one of your criteria in the 12 projects that you looked at, 7 of which you approved and 5 of which we do not know whether you approved or disapproved or they were withdrawn.

So of the seven that were approved, I am taking it that Treasury agreed with FOMENTO that there was no negative impact on Puerto Rico and that was part of your criteria on signing off on it. Or is that an incorrect assumption?

Mr. GIDEON. There are two signoff authorities, Mr. Anthony. We applied essentially provisions consistent with what is stated in our regulations. But the Puerto Ricans also have their own regulations which they apply.

Mr. ANTHONY. So the answer is that you did not take into consideration any negative impact on Puerto Rico since that requirement is not contained in the legislative history.

Mr. GIDEON. Well, that is not a part of the requirements that we impose.

Mr. ANTHONY. That you impose.

So going by the requirements that you impose, you did not consider whether it had a negative impact on Puerto Rico?

Mr. GIDEON. That is correct.

Mr. ANTHONY. So if a decision were made that it had a negative impact on Puerto Rico, it would come from FOMENTO?

Mr. GIDEON. Yes, as the testimony states.

Mr. ANTHONY. But the way that you review and sign off on CBI projects, if FOMENTO said no, then the deal is dead?

Mr. GIDEON. It requires, the mechanism here requires——

Mr. ANTHONY. Requires both?

Mr. GIDEON. Requires both.

Mr. ANTHONY. So by anybody's reasoning, that requirement has worked its way into being one of the requirements. I guess what I am trying to figure out is, how did it work its way into being a requirement if it is not in the legislative history? Or does the government of Puerto Rico have the right to rewrite the legislative history?

Mr. GIDEON. Well, I think you ought to ask the Puerto Ricans that.

Mr. ANTHONY. Well, I will ask them. I was trying to figure out where you came at it first.

Chairman PICKLE. Well, Mr. Gideon, we asked you that, should that be the way it should operate?

Mr. GIDEON. Well, I think that our objective has been to try to implement the law as we found it, And we have not tried to add to or detract from what we consider to be the marching orders we received in 1986.

Mr. ANTHONY. Well, I guess that's what I am trying to determine because I have been a very, very strong supporter of the Caribbean Basin, and was one of the first members that went down on an oversight hearing at the request of President Reagan, and came back a big supporter of CBI–I, and am a big supporter of CBI–II.

I happen to be a big believer that 936 might not be such a bad provision. But when the twin-plant concept came up, I was also privy to some of the conversations. It appears that it is so unclear the maybe we need to go back and draft some new statutory language and get it out of the hands of the unknown, or otherwise we are not going to have the correct oversight that Mr. Schulze mentioned awhile ago—the scorecard.

I think that is really all we are trying to do here. I guess it is disappointing that for the public record we are crippled by section 6103 where all of these projects have been well discussed and well documented publicly. Yet, we are constrained and are barely able to talk about it in a congressional hearing for the sole purpose of doing proper oversight on 936.

There is something inconsistent about our Government when the official committee cannot get the questions in open session which it can go read about it in periodicals, because they have the privilege of going and interviewing all the witnesses and then writing an article. It is disappointing to say the least.

Mr. Chairman, I will just close with two additional comments and a final question.

Chairman PICKLE. Oh, yes, the final question.

Mr. Secretary, I asked you awhile ago, I wanted you to ask for an individual waiver of these individual taxpayers. Are you willing to do that?

Mr. GIDEON. Certainly.

Chairman PICKLE. Thank you.

Mr. ANTHONY. Ken, I guess what disturbs me is when you start talking about the twin-plant concept, you are really talking about trying to create jobs. I know that is what I had in mind.

In other words, if you could share the bounty from Puerto Rico with some of the smaller democracies in the Caribbean, you could create new jobs.

What disturbs me about Air Jamaica is that I cannot find evidence that a single job has been created. And it seems to me that they are going to be making a lot of money off the transaction. It also seems to me some of the profits have been siphoned off in terms of lower costs, and there are higher costs being paid by the government of Jamaica because of this intermediary who found a very creative way to game the system. It took over a year to do it and had to go through a very convoluted process in order to get there. They get FOMENTO to sign off on it. They get American Express to back it. American Express is not even graded high enough in the market because their rating is graded as A. They need a double A. So they have got to go to another bank to guarantee their guarantee.

When you look at this transaction, it just seemed to me that it was a very obvious attempt to try to tie into some cheaper financing. And you had some very creative people out there, and then you find out that the 10-year notes were being processed by an outfit called Drexel Burnham Lambert.

I can just tell you that it does not read good, it does not sound good. I would hope that, in the future, we could be a little bit more straightforward, or maybe we can find a more simplified method by which we can disburse 936 funds.

But if you can tell me, or if future witnesses can tell me where additional jobs have been created by this transaction, I will be very interested in hearing it.

I also happen to be a big supporter of tax-exempt financing. And I worked a great deal on the arbitrage rebate provision, and you worked with us, and we were able to straighten that out last year.

But when I read that AT&T was able to tap in to 936 funds, I mean bells and jingles and red flags start waving. I, for the life of me, cannot see where a company as big and as creditworthy as AT&T could legitimately qualify or should be given any type of priority to lay down some of their fiber optic cable in one small segment in the Caribbean when they didn't use it any place else. I cannot believe that they could not go to the regular marketplace, find the money, and that allow some other deserving entrepreneur to have access to the capital.

I have just got to believe there are some disappointed business people down in that area, when they see the big boys like AT&T, and these leasing people, come in and get these huge amounts of money when they are getting a mere pittance. I can tell you I for one did not back up the twin-plant concept to see these big guys come in there and rip off the treasury. I backed it to see the little

bitty guys get a chance to get some funding and to create some local jobs.

I would ask that the chairman of this committee set up a private session with you under the proper guidelines of the protection of 6103, and give us the opportunity to go through all 12 of those transactions so that we could get a very clear and firm understanding as to how complicated it is, and if we can come out with some ideas to simplify it, and also maybe some restrictions to redirect it so that it gets to where we think it really deserves.

So, with that, I yield back the balance of my time.

Chairman PICKLE. Well, Mr. Gideon, were there any jobs created in the Air Jamaica lease-sale transaction?

Mr. GIDEON. Again, Mr. Chairman, I cannot comment today on specific transactions.

Chairman PICKLE. Now, Mr. Gideon, you can comment on that. You know that there were no jobs created by that, practically none. And there is not any point in you being coy about it. We know that and you know it too.

I do not know what statute protects you, but maybe there is one that can. Were there any jobs created by the AT&T transaction?

Mr. GIDEON. Again, I cannot comment on this specific transaction, Mr. Pickle.

Chairman PICKLE. Well, there were not. Would that project have gone ahead anyway, the AT&T project, if 936 funds were not available?

Mr. GIDEON. Again, I cannot comment today on specific transactions.

Chairman PICKLE. Well, Mr. Gideon, it would have, and we all know it because that was one leg of five or six different Caribbean areas. That would have gone ahead. It was just a means of getting some cheap interest, low interest and financing.

And I think the parties involved wanted to see some money moved, so they moved it that way. That is simply what happened, is that correct?

Mr. GIDEON. Again, I cannot comment in open session today on specific transactions.

Chairman PICKLE. Well, Mr. Gideon, I ask you, when Treasury determined that it would issue a no objection letter, what standard did you use? Were jobs one of the considerations?

Mr. GIDEON. No. We attempted to apply the standards that we discerned in the statute. We believe that our regulations are consistent with the statute.

Indeed, Mr. Pickle, you are likely to hear some criticism today that our regulations are too restrictive. We tried, as best we could, to implement what we thought Congress told us to do.

Chairman PICKLE. Yes. Well, I submit to you, Mr. Secretary, that I do not think the Treasury did take in consideration as one of their standards whether it created jobs or not. And it would appear to me that would be your interpretation too.

Well, Mr. McGrath, do you have any questions?

Mr. MCGRATH. Yes. Thank you, Mr. Chairman, and thank you, Mr. Gideon. I am not going to ask you any questions you cannot answer. Let me ask you this.

We are sort of stuck here today, trying to understand whether or not there was any real agreement or whether any written agreement on this twin plant concept, and whether or not the requirement for the government of Puerto Rico to loan moneys into the CBI countries was done in the same spirit in which the Congress had intended.

Rather than get into specifics, I thought perhaps we could find out whether or not the manner in which we are lending or the process that exists in lending for these projects in these countries is the manner which it ought to be.

Now, let me ask you this. Would it improve the lending of 936 funds for Caribbean development if financial institutions could make qualified loans, using the same due diligence and fiduciary standards which exist to make commercial loans in Puerto Rico? That is, can we eliminate the case-by-case approval of the Puerto Rican Commissioner of Financial Institutions?

Mr. GIDEON. We would have some concerns with that, Mr. McGrath. I think the problem is that someone needs to supervise compliance. And it is going to be important that someone is monitoring that this money is being spent in the manner that you intended it to be spent.

Our ability to audit in these situations is somewhat limited. Given the fact that these are not—I mean the projects are outside the United States and, as a result, it is important that there be oversight over the projects in some manner to assure that the money is being spent in the manner that Congress intended.

Mr. MCGRATH. All right. Then let me ask you this.

Would it improve the lending of 936 funds for Caribbean development if 936 corporations could make direct 936 investments in the Caribbean? Right now they can only be done through financial institutions outside of Puerto Rico.

Mr. GIDEON. That is, I think, a possibility again. The question is going to be how will you monitor any standards that you apply in that area?

Mr. MCGRATH. I thank you for your testimony.

Chairman PICKLE. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Other subcommittee business prevented me from being here for Mr. Gideon's testimony. I have, however, reviewed much of it, and I know that I don't want to repeat any questions that have been asked before.

I know there is concern here about how does this 936 program work. Does it work effectively, does it create jobs?

Let me just ask you, Mr. Gideon, a followup question to something that was just asked a moment ago.

When someone asked you about one of the items that represented an investment of 936 funds, and whether it created jobs, you indicated that you felt that you comported to law and regulations and congressional intent.

Does that suggest that there is not in regulation or law, or your interpretation of congressional intent that jobs, the creation of jobs represents a major component of what we are trying to do with all of this?

Mr. GIDEON. Well, specifically, the regs provide for the funding of development, new development projects. Obviously, the hope is that those projects will create employment in the local economies where they are placed.

In other words, we don't specifically look at the issue of job creation beyond that general requirement that this be a new development project in the country.

Mr. DORGAN. What if it is a development project that is simply paper transactions, without a lot of jobs, but we are doing business and making money?

Is that fine or does there need to be in the general scheme of things, as you suggested, some notion of job creation? And if so, how is that manifested in the decisions Treasury would make?

Mr. GIDEON. Well, we have basically interpreted the rules to apply to projects. In other words, development, specific kinds of projects in the areas that had to do with funding industries in those countries.

Mr. DORGAN. But if Mr. Anthony and I today have a little project where we are trading commercial paper back and forth and making money doing speculative paper trade, is that a project?

Mr. GIDEON. I don't think that would meet our view of a project.

Mr. DORGAN. So your view of a project would be something that goes beyond that and actually creates employment?

Mr. GIDEON. Yes. Specifically, a development project that has to do with an industry in the benefited country.

Mr. DORGAN. And if it is something that includes the creation of employment, is that just a kind of amorphous description, or is there some definition to the creation of employment that you described?

Mr. GIDEON. Well, there is not a specific requirement you will create *x* jobs in the regulations.

Mr. DORGAN. But there is an understanding by you that you will create jobs?

Mr. GIDEON. Well, that there will be a development project in the country.

Mr. DORGAN. That creates jobs, or do you care about that?

Mr. GIDEON. Well, I think that it is implicit if you are creating a new industrial development or a new business enterprise in the country that there would be job creation associated with that.

Mr. DORGAN. I don't mean to belabor this, but the reason it is important, it seems to me, is it probably responds to the questions that some of us will ultimately ask. Do we need to make some changes here to tighten this requirement down that these be real job creating and, if so, what are the descriptions that we would use?

I can conceive of a whole range of projects that one might develop that don't create any jobs. I could have a one-room office buying and selling spot oil. This doesn't create any jobs, but probably I have some need for capital. And I am just wondering whether that would pass your test.

Mr. GIDEON. Well, again, remember that our working capital requirement in the regulations, in other words, you cannot just finance working capital, it has got to be associated with a project in some former fashion.

In other words, what we tried to do is implement the guidance we were given. Now, we published last September, and I think if the committee looking at that publication thinks that we have not been restrictive enough—and it should look at those rules and decide what further action it thinks ought to be taken.

Mr. DORGAN. Well, the question raised earlier about the airplanes, I do not know much about that. But it does seem to me that we would want to be doing things that attempt, so far as possible, to be job creating. And if the current law does not accomplish that, maybe we need to make some changes. Maybe you could help us in evaluating what, if any, changes are necessary to give you the ability to look at that in a different way to sort out what really represents the ability to create new jobs and what does not.

So I am not trying to badger you by asking this question. I am trying to understand where we go with this to accomplish what most of us want to accomplish. I really want to see development in Puerto Rico and development in the region occur in a way that makes a lot of sense. If ever a part of this world needs that assistance, it seems to me it is our neighbor.

So the question is not whether, the question is how. And if you at Treasury have some suggestions on this issue of guidelines in terms of what is job creating and how we might interpret that legislatively, I would certainly appreciate receiving that from you.

Mr. GIDEON. We would be happy to work with the subcommittee on that, Mr. Dorgan.

Mr. DORGAN. All right. Thank you very much, Mr. Chairman.

Chairman PICKLE. Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

Mr. Secretary, I am interested in two things, the economy in Puerto Rico and support for the Caribbean Basin Initiatives.

First of all, do we have an overall plan for the economic development of Puerto Rico that your office may supervise to see how we are doing in terms of job creation? Are you involved in that at all?

Mr. GIDEON. No.

Mr. RANGEL. You are not?

Mr. GIDEON. I mean we are not in the Tax Policy Office supervising the Puerto Rican economy.

Mr. RANGEL. I understand. I have other questions so you are not involved in that.

Do you have someone that monitors the jobs that may be attributed directly or indirectly to the 936 program?

Mr. GIDEON. We do file regular reports as mandated by the Congress on that.

Mr. RANGEL. And how many jobs, what percentage of the employment in Puerto Rico would you attribute to the 936 program? Well, someone said from Puerto Rico two-thirds. Does that sound ridiculous or——

Mr. GIDEON. I do not think that we would agree with that number. We think that——

Mr. RANGEL. Well, just make up one. I do not care. [Laughter.]

Mr. GIDEON. About 100,000 jobs.

Mr. RANGEL. What percentage of the employment in Puerto Rico would you attribute directly or indirectly to the 936 program? I have no way of knowing.

Mr. GIDEON. About 10.

Mr. RANGEL. Ten percent?

Mr. GIDEON. Yes.

Mr. RANGEL. Directly?

Mr. GIDEON. In terms of what we counted in the reports that we filed.

Mr. RANGEL. Now, what about the indirect jobs, those that provide the support system in maintaining these factories and whatnot, do you attach any jobs to that?

Mr. GIDEON. There has been a lot of controversy about how far you can carry the linkage——

Mr. RANGEL. I mean noncontroversial. I might accept anything you tell me. I just want to find out really whether or not there are any jobs created by 936. Because, if there is not, we should not have it.

Mr. GIDEON. I do not think there is any question that some jobs are created by 936.

Mr. RANGEL. OK. Now, let's talk about that I am trying to find out is how essential is 936 to the economy in Puerto Rico since it is the only thing I know that we have got? You see, I am not in love with 936. I think it is the only thing we have got. I think that is our national economic recovery for the government of Puerto Rico.

So my question is how is it working? How many jobs are being created?

Mr. GIDEON. It has created some jobs in Puerto Rico.

Mr. RANGEL. Is it the only economic development program that the U.S. Government has in Puerto Rico?

Mr. GIDEON. It is certainly the one that is the most visible.

Mr. RANGEL. Great. Now, tell me the one that is not so visible.

Mr. GIDEON. I think that Puerto Rico participates in a whole series of other Government programs——

Mr. RANGEL. Well, so does New York State.

Mr. GIDEON. I agree with that. In other words——

Mr. RANGEL. Well, we can vote, you know, so listen to me, Mr. Secretary.

Section 936 may not be the best thing that we should be doing for Puerto Rico. But I think it is clear from your testimony that it is the only thing we have. And that the best that we can do is perfect it.

Mr. GIDEON. As I said earlier in response to a question, we are not up here to revise specification.

Mr. RANGEL. OK. Now, that we got your unequivocal support for 936, let's move swiftly——

Chairman PICKLE. I don't believe that was the answer of Mr. Rangel. I don't believe that was his full answer.

Mr. RANGEL. I am trying to do what you have done so effectively, and to interpret my questions for the record as opposed to his answers, Mr. Chairman. [Laughter.]

Now, let's move swiftly to the Caribbean Basin Initiative which, as far as I am concerned, is an integral part of our foreign policy.

Whose idea was it that 936 funds could not be used by one of these Caribbean countries unless that country signed a tax information exchange treaty?

Mr. GIDEON. Ours, the administration's.

Mr. RANGEL. Who responsibility was it to get these countries to sign these tax exchange treaties?

Mr. GIDEON. We have approached almost all of them at this point, with varying degrees of success.

Mr. RANGEL. But it is our responsibility as partners in the treaty to get them to sign, wouldn't you say?

Mr. GIDEON. We have approached virtually all of them, Mr. Rangel.

Mr. RANGEL. So it would be safe to say that where we have been unsuccessful, the government of Puerto Rico could not be considered unsuccessful if they did not make those funds available to countries who did not sign those treaties?

Mr. GIDEON. I think that it was a clear requirement that there be a tax information exchange agreement.

Mr. RANGEL. So if they don't have the agreement, we don't look for any progress from that particular country, would 't you say?

Mr. GIDEON. That is correct. I think that there has been a lot more interest and we have seen a lot of progress on that front lately.

Mr. RANGEL. I would agree with you. I think Treasury has done a fantastic job in getting these countries signed up. As a matter of fact, I think Treasury has moved forward to get regulations to guide the performance that we expect from these countries. Wouldn't you agree?

Mr. GIDEON. Well, we put out regulations in last fall in order to help people understand——

Mr. RANGEL. And prior to last fall, you wouldn't expect too much progress until our Treasury got those regs together, would you?

Mr. GIDEON. I think that we were available to do case-by-case work at that time.

Mr. RANGEL. I know. But we are talking about the entire Caribbean. Case-by-case means, you know, small progress. But now that we have got guidelines, we expect a lot more progress being made in this area, wouldn't you think?

Mr. GIDEON. We would certainly hope so.

Mr. RANGEL. So, with regulations and tax information exchange agreements, we expect to see more than we have in the past.

Mr. GIDEON. Absolutely.

Mr. RANGEL. An we should not have expected much more without the treaties certainly?

Mr. GIDEON. You certainly cannot go into a country where there is not——

Mr. RANGEL. And the regulations, of course, help.

Mr. GIDEON. And the regulations should be of help to us.

Mr. RANGEL. Now, I do not want to get involved in these secret agreements that took place with Treasury. But, in full generic terms, countries that are noted for their tourism, would you not believe that hotels and transportation are an essential part of that business?

Mr. GIDEON. Well, I think that hotels are certainly an important part of that. And getting people there would be an important part of it as well.

Mr. RANGEL. And would you not think that if a major business of a country was tourism, that getting people there would create the

jobs which is essential for a country dependent on tourism, wouldn't you think?

Mr. GIDEON. I would think that there should be some job creation involved in the transportation system.

Mr. RANGEL. And if people were having a problem getting people, tourists, to that particular site, then that could be a loss of jobs, isn't that so?

Mr. GIDEON. It would certainly help if they could be moved to the site efficiently.

Mr. RANGEL. So if we could help countries that we want to help to get transportation if, indeed, they are involved in tourist, then that would certainly fall within the framework of the Caribbean Basin Initiative, wouldn't you say?

Mr. GIDEON. I think that assisting economic development projects in these countries is an important part of this.

Mr. RANGEL. And anything that Puerto Rico can do to encourage that is exactly what we wanted when we passed the twin-plant concept, isn't that so?

Mr. GIDEON. I think that assisting real economic development in these countries is what I think the objective was.

Mr. RANGEL. And tourism is real economic development?

Mr. GIDEON. I think it can be.

Mr. RANGEL. Well, in the case of Jamaica, is tourism real economic development?

Mr. GIDEON. I think in the case of Jamaica, tourism is important.

Mr. RANGEL. And essential to Jamaica?

Mr. GIDEON. I would not consider myself qualified to answer that question.

Mr. RANGEL. Well, if being unqualified, can you imagine Jamaica without tourism?

Mr. GIDEON. Well, I have not been there so I don't know.

Mr. RANGEL. I think you have answered the question, that it is very important that we have effective transportation to countries who depend on tourism as a part of the economy.

Mr. GIDEON. I think that a good infrastructure is necessary to any economy.

Mr. RANGEL. Do you find any step up in the regulations oversight by Treasury? These hearings, I think, are essential for the Congress to know and, therefore, the American people, what is going on in Puerto Rico, and really what is going on in the Caribbean with this twin plant concept.

And I wanted to thank the chairman for his vigilance in pursuing this subject matter.

What is Treasury doing in this area? Are there periodic oversights to studies being made on Puerto Rico? Do you work with the State Department to support this initiative, not just for the economic development of the Caribbean but as a part of our foreign policy?

It is my understanding this whole concept came out of the State Department, not Treasury.

Mr. GIDEON. We do our part in implementing this program by providing the appropriate guidance.

Mr. RANGEL. Tax wise?

Mr. GIDEON. Tax wise.

Mr. RANGEL. Who should I go to to find out from a foreign policy viewpoint who is responsible for this program?

Mr. GIDEON. For the CBI program generally?

Mr. RANGEL. Well, our piece of it, you know, the point that we are talking about now.

I mean when members are saying does this create jobs, I want to know the answer to that. And obviously you are not into the job mode, but there should be somebody that is concerned as to whether these fragile democracies are having jobs created, and whether or not this small sliver of broad legislation, over which we have jurisdiction, is helping or whether it is a part of the problem.

Now, you cannot answer it. But who is it that you know that you work with that may have better answers to whether this program is helping those people in the Caribbean?

Mr. GIDEON. Well, I think that you are going to talk to the Puerto Rican authorities who have direct approval authority later today.

Mr. RANGEL. But that would be self-serving. I am saying that helping those Caribbean countries is a part of our foreign policy. That is not disputed.

Mr. GIDEON. That is absolutely true.

Mr. RANGEL. And as Mr. Anthony said, this committee went to the Caribbean and made a commitment that we wanted to help those countries.

In the course of developing a network of legislation, 936 became a part of that. Now, are you telling me that you monitor whether or not the tax exchange treaties are being fulfilled, or whether or not they are obeying the law?

But who is responsible for helping us to see whether or not 936 is helping those countries?

Mr. GIDEON. I think that one of the things that you may want to look into, Mr. Rangel, is the need for providing a direct oversight function of that sort.

Mr. RANGEL. OK. So it is no sense knocking it. As far as you are concerned, you don't know anything that is not going right over there as far as our policy in the Caribbean and 936?

Mr. GIDEON. We have attempted to make sure that the program operated under the guidelines as we understood them.

Mr. RANGEL. OK. So this is the greatest thing that we have going in Puerto Rico and the Caribbean. And I want to thank you for your contribution.

Thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Rangel.

Mr. Secretary, the Treasury has issued some temporary regulations that would limit the interest rates charged by financial intermediaries I presume to be sure that the amount of interest paid to an intermediary would have to be fair and reasonable.

Why did you put such a limitation in your regs?

Mr. GIDEON. We were concerned that the benefit of 936 funding go to the project funded as opposed to being siphoned off through a series of intermediaries. That is the reason we have a limitation of the number of financial intermediaries in the chain as well.

Chairman PICKLE. Well, the information we have from the press and other sources indicates that the deal maker on the Air Jamai-

ca project would receive somewhere in the neighborhood of $1 million annually for 4 or 5 years, and that the interest rate was pretty high.

I don't suppose you would be in a position to say what that interest rate was. But at least your regulations now would try to control that, is that correct?

Mr. GIDEON. We certainly would try to assure that the benefit of 936 funding would flow through to the ultimate borrower.

Chairman PICKLE. All right. Now, if you have issued now regulations, and these temporary regulations that in effect said that no longer would Treasury issue these no objection statements, doesn't that mean that from now on that the supervision of the 936/CBI program is going to be between Puerto Rico and the Caribbean nations?

Mr. GIDEON. I think that, in large part, that is pretty much so, Mr. Pickle. In other words, our ability to audit in these situations is quite limited.

Chairman PICKLE. And now without no objection letters, you are even more limited?

Mr. GIDEON. It would be fair to say——

Chairman PICKLE. Because they have to get your approval.

Mr. GIDEON. They do not have to get our—they never did.

Chairman PICKLE. They don't have the Internal Revenue Service's opinion. They approve it or not approve it.

Mr. GIDEON. They never had to do that. They chose to come to us voluntarily in order to help us develop guidelines for the program.

Chairman PICKLE. Now, with respect to the TIEA, that is the tax treaty, how many tax treaties do we have in the Caribbean nation area?

Mr. GIDEON. Six now.

Chairman PICKLE. Six.

Mr. GIDEON. And two in——

Chairman PICKLE. And how many more do we not have?

Mr. GIDEON. There are 22 countries altogether.

Chairman PICKLE. Twenty two. So you have got 6 out of 22.

And you had stated earlier, if I understand it, that you, Treasury, had been seeking tax treaty agreements with all of the 22.

Mr. GIDEON. Yes. I think we have had contacts with virtually all of them, if not all.

Chairman PICKLE. You have six now. Are there any other nations of the 22 in the process of signing these treaties?

Mr. GIDEON. We have two in process that have not been ratified yet.

Chairman PICKLE. Two that have been approved and not ratified.

Mr. GIDEON. Right.

Chairman PICKLE. Can you identify those?

Mr. GIDEON. Costa Rica and Saint Lucia.

Chairman PICKLE. Costa Rica and who?

Mr. GIDEON. Saint Lucia.

Chairman PICKLE. Saint Lucia. All right.

Now, why has it taken so long now? We had sought these tax treaties years before. Why has it taken so long to get these tax treaty agreements?

Mr. GIDEON. Well, I think that the country on the other side has to agree. They have to perceive that it is in their interest to enter into such an agreement.

I think that we are making progress in convincing people that that is in their interest. But, frankly, my experience in the international agreement area generally is that that has never been a quick process.

Chairman PICKLE. Well, have potential political problems been part of that aspect?

Mr. GIDEON. Political in what sense, Mr. Pickle? I am not sure I understand the question.

Chairman PICKLE. Well, would the fact that they might have some tax havens be more important to a nation than to have a tax treaty with us?

Mr. GIDEON. Well, I would not want to speculate on their motives. I think that our objective and discouraging that behavior has been clear. And I am heartened by our recent progress.

Chairman PICKLE. Well, if we were to get all the nations to sign a tax agreement with the United States, and if we could get the 936/CBI program working in a more equitable and more helpful manner, that would be to everybody's advantage, would it not?

Mr. GIDEON. I think that improving efficiency in these programs, and broadening their reach in the Caribbean would clearly be a good thing.

Chairman PICKLE. Yes. Can you venture to tell me why a nation would not have a tax treaty with us?

Mr. GIDEON. I think that our negotiating experience has been that there is frequently a lot of resistance to this kind of information sharing with foreign governments.

Many people in these countries are distrustful, even of their own revenue services and the idea that information would be shared with another revenue service. It takes awhile to convince them of the benefits.

Chairman PICKLE. Does Treasury have any proposal to make with respect to the 936/CBI program at this point?

Mr. GIDEON. Not at this point, Mr. Pickle.

Chairman PICKLE. I take that to mean that you might, but not at this point?

Mr. GIDEON. That is correct.

Chairman PICKLE. All right. Let me ask the other members if they have other questions there.

Mr. Anthony.

[No response.]

Chairman PICKLE. Mr. Dorgan.

[No response.]

Chairman PICKLE. Mr. Guarini, did you want to make any statement? I am glad to have you with us today. You have been very active in the CBI program.

Mr. GUARINI. Well, thank you, Mr. Chairman.

I want to commend you for bringing to focus an important issue on tax policy and get a better understanding of the needs of Puerto Rico and our tax requirements.

I just want to ask, why did it take so long to issue regulations for qualified investments? It took over 3 years. Is there a reason why

the Treasury dragged its feet when they knew there was an imperative from Congress to get something done?

Mr. GIDEON. I think that this was not a case of foot dragging. Certainly I got there in June. We issued regs in September. I cannot speak about people on prior watches.

I would also say though that in this area there was a real need to find out how these transactions were going to look. The case-by-case guidance program which commenced from day one, and was available to everyone, was very useful in helping us develop those regulations. But this is not a situation where people could not get guidance. They could.

Mr. GUARINI. But Congress did give a directive to Treasury to get these programs going as fast as they can. And I am just wondering whether or not there was any interference by the State Department anywhere along the way in getting the regulations done properly on time?

And did they interfere in the Air Jamaica case or any of these other areas that people have interrogated?

Mr. GIDEON. I cannot comment on specific cases, Mr. Guarini. But certainly the State Department did not interfere in the issuance of the regulations.

Mr. GUARINI. Why are there no regulations on privatization issues? I should imagine with these islands that could be a very important issue.

Mr. GIDEON. It is an important issue. It is also a difficult area to define. And we have diligently sought comment from the international development agencies to help us develop appropriate standards.

Mr. GUARINI. So, in 3 years, you still have not addressed the issue of privatization, is that correct?

Mr. GIDEON. That is correct.

Mr. GUARINI. And why has it been taking you so long to get TIEA approved when we have such a close relationship with these 23 Caribbean and Central America countries? Out of the 23 until last year only four approved, which gave very little latitude to be able to get these loans executed.

And of the four approved, one island, Grenada, we invaded, and the other island, we already had a TIEA before the requirements of 936. So, therefore, our track records for 3 years is really only 2 that we put on line that we had convinced out of 23. This is a very slow difficult process.

Why do you think the Treasury Department has been so ineffective in getting the TIEA approved?

Mr. GIDEON. It takes two to tango on that. In other words, those are international agreements. And we can solicit, as we did, agreement. But until people are willing to sign, there will be no agreement.

Mr. GUARINI. Well, what have been the road blocks? Where have been the problems that you have difficulty in being successful in these other 19 countries until last year to get approved?

Have there been any particular reasons why we have been ineffective with the national program?

Mr. GIDEON. I think some of these countries simply have not perceived it as in their interest to sign such agreements.

Mr. GUARINI. Not in their interest to get loans from twin plants and be able to build an infrastructure and be able to develop their economy?

Is there any underlying particular reason why you think there has been a resistance?

Mr. GIDEON. I think that there has been resistance in some places because of the disclosure requirements of TIEAs.

Mr. GUARINI. So that Puerto Rico, if there are not the approvals of a TIEA, certainly could not be faulted for not making loans to these other countries because they had a very small marketplace to go to, is that correct?

Mr. GIDEON. Certainly they could not make loans in places where there was no TIEA because Congress' command there was explicit.

Mr. GUARINI. And the Treasury Department bears some of the responsibility in getting the wherewithal of having these loans made.

Mr. GIDEON. We have diligently sought TIEAs with the CBI countries.

Mr. GUARINI. All right. Thank you.

Mr. RANGEL. Mr. Chairman, may I ask one question?

Chairman PICKLE. Yes, Mr. Rangel.

Mr. RANGEL. This concerns cost sharing. I think we have had an exchange of letters on that, Mr. Secretary. And I think it is safe to say that, at one time, the administration intended to wipe out 936 and to substitute it with that wage credit which you and I have since rejected.

But, in the papers, to indicate why 936 was retained, the record clearly indicates that then Secretary of Treasury Baker and the State Department and National Security Council, the Vice President's office joined with Treasury in retaining section 936, and throughout all of the documents that I have been able to get, and it said, "and retained the cost sharing election."

And even in the document put out by our committee, the language that governs in deciding to make relatively minor modifications to the credit,

> The committee has been motivated in a large part by representations made by the government of Puerto Rico that it intends to pursue vigorously the twin plant initiative outlined in the memorandum of agreement.

I read that because it is my understanding that Treasury intends to wipe out or to so modify the cost sharing election that it may not be effective.

Could you share with me your views on that?

Mr. GIDEON. As you know, Treasury published a white paper on section 482, that generally has to do with the issue of transfer pricing, not merely with respect to Puerto Rico, but with respect to all transactions between foreign countries and U.S. companies.

We still have that white paper. It is not a proposed regulation.

Mr. RANGEL. OK.

Mr. GIDEON. It was a study draft under review. We have not made final decision with respect to it.

Mr. RANGEL. But then the law exists, the 936 law, and the election of cost credit option, the cost-sharing election so exists as it did before.

Mr. GIDEON. Certainly the statute says what it says, Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Rangel.

Now, Mr. Gideon, let me ask you just one or two more questions before we go on.

Has Treasury or the Internal Revenue Service heard from the State Department since enactment of section 936(d)(4) about any pending 936/CBI loans?

Mr. GIDEON. Not specific loans, Mr. Pickle.

Chairman PICKLE. I beg your pardon?

Mr. GIDEON. Not specific loans. We have consulted with them on regulatory issues.

Chairman PICKLE. Can you tell me who contacted you, the State Department?

Mr. GIDEON. No. In terms of the privatization issue, we solicited help from the State Department, from AID, from OPEC and from others to try to develop standards to apply that part of the program.

Chairman PICKLE. Then you are saying the State Department has not contacted Treasury or IRS on any of these loans which have been pending since 936 was enacted 3 years ago?

Mr. GIDEON. As to specific loans in the Treasury Department——

Chairman PICKLE. Any loan program.

Mr. GIDEON. I am informed there may have been some contacts before the regulations were issued. But again, as in terms of specific cases, I cannot comment on that.

Chairman PICKLE. In other words, you are saying you don't know whether there have been any contacts or not?

Have there been any made with you or previous Treasury officials?

Mr. GIDEON. None made with me, Mr. Pickle. I cannot speak of prior Treasury officials.

Chairman PICKLE. All right. Now, let me just hastily go to one or two other questions here.

Back in 1985, when Puerto Rico presented its memorandum of understanding, was the State Department involved in the debate about the future of 936.

Mr. GIDEON. It is my understanding they were. I was not here.

Chairman PICKLE. Did the State Department then take the position that retention of 936 was a national security issue?

Mr. GIDEON. That is my understanding.

Chairman PICKLE. Now, can you tell me what the national security issue was?

Mr. GIDEON. I think that the concern at that time, as indeed as it continues, is that the well-being of the economies in the Caribbean was vital to security interests of the United States.

Chairman PICKLE. Well, what do you mean by that, sir?

Mr. GIDEON. Well, I mean that I think that we believe that free economies in those countries are beneficial to us, and that we could be seriously threatened if there were governments hostile to us in——

Chairman PICKLE. Are you saying then that the approval of the 936 program was broad enough that that was in our national security interest?

Mr. GIDEON. I think that the CBI portion of this program was certainly perceived as enhancing that.

Chairman PICKLE. In your opinion, is a national security issue still valid today?

Mr. GIDEON. I think that it is still very much in our interest to assist those economies.

Chairman PICKLE. From a defense standpoint?

Mr. GIDEON. I would not consider myself qualified to speak on defense issues.

Chairman PICKLE. Military standpoint?

Mr. GIDEON. I could not speak to that.

Chairman PICKLE. Just have good relations with the nations?

Mr. GIDEON. Well, I think it is more important than good relations. I think it is——

Chairman PICKLE. Well, this program is commonly referred to as the twin plant initiative. It is really not a twin plant initiative. Would you say it is a twin plant initiative? Would that be an appropriate phrase from you?

Mr. GIDEON. I think that that is the way some of it was presented initially, but I do not think that it is true that all of these projects have involved twin plants.

Chairman PICKLE. Well, I would think that would be your answer because the projects that Treasury has approved were not twin plants, were they?

Mr. GIDEON. For the most part, I think that is correct.

Chairman PICKLE. They are not then. Do the regulations that you have adopted at this point allow for facilities that are not twin plants?

Mr. GIDEON. Yes.

Chairman PICKLE. Now, you made a statement in your testimony that you, Treasury, would approve, "we conclude that the Federal guarantee of section 936 funds should be allowed because the purpose of the section 936/CBI program is sufficiently different from that of municipal bonds."

So you are for the Federal guarantee. Are you saying that you are for the U.S. Federal guarantee?

Mr. GIDEON. We said that we did not think that should be disqualifying. In other words, specifically what we had in mind——

Chairman PICKLE. Now we are giving 936 companies interest-free treatment for income from active businesses. We give them tax-free treatment on the QPSII. And now you want to give them a Federal guarantee of any loans made. Mr. Secretary, is not that a double-dip credit?

Mr. GIDEON. We simply made the decision that the kinds of guarantees that are available through OPIC, for example, should not be disqualifying to these projects.

Chairman PICKLE. Well, would you venture a position. Should Puerto Rico make them a guarantee? They got $15 billion down there on deposit?

Mr. GIDEON. We think, in fact, as I have noted in my testimony, the Puerto Ricans have created an entity to make guarantees and I think they may very well do so. And it would seem to me that we would not want those guarantees to be disqualifying either.

Chairman PICKLE. Well, it would seem to me that just for us to step up and say, we will make a guarantee is an outrageous position for our government to make, without any consideration of Puerto Rico's involvement. And I would hope that we would examine that position carefully.

Now, I want to conclude by making this statement to you, Mr. Secretary. With the pool of 936 funds on deposit in Puerto Rico, that island is in a unique position. It has got on hand now $15 billion, fluctuating, that it can tap for economic development purposes. With its support for Puerto Rico's $100 million commitment back in 1985, the administration put its mark of approval on the 936/CBI loan program. This committee approved it. But we want the program to be successful. We think it is in our national interest. I do not know that I can say it is in our national security interest, but we do want it to succeed.

And this administration has been a strong advocate for the CBI, although this administration has not helped us get any bill passed over on the other side, in the Senate and I hope that you can do that. Maybe it is time that we take a look at 936 to see whether the whole CBI, the 936/CBI loan program is the best way to channel development into the CBI countries?

I say that maybe it is time that we take a look at the overall operation of 936 to see whether a wage credit would be a more efficient way of promoting employment. These are serious questions that we are going to be looking at because we want the program to be successful.

But I also make the final observation, that even if the $100 million guarantee is lived up to—which it has not been—but if it has been lived up to, that would still represent only less than 1 percent of the 936 money involved down there.

And I think that we have to start thinking, making comparisons about the totality of the overall program. That is why we are looking into some of these things.

I want to thank you for your testimony and for your participation.

Mr. CHANDLER. Mr. Chairman.

Chairman PICKLE. And I want to say to you that we are going to have additional hearings on some of these questions.

Mr. CHANDLER. Mr. Chairman, would you yield for one question, please and stop me if this has been already asked.

Mr. Gideon, in your testimony, on page 4, you say, the goal of the CBI program is to promote economic development in CBI countries by encouraging new investments. I agree with that goal. I believe that the committee does as well. The question that I have though is about the decision making process on the loans that are made. Is this the most efficient way to promote economic development by requiring that a potential lender gain the approval of the Commissioner of Financial Institutions of Puerto Rico and the Economic Development Administration, FOMENTO?

In a sense we never have a decision made here, in the United States. It is not a decision that is made in the interest of Puerto Rico and the rest of the CBI. It is, as I understand it, a decision that is made in Puerto Rico for the rest of CBI. It seems to be an

odd structure, an odd decision making process. Is there room for reform there to improve that?

Mr. GIDEON. As I stated earlier, Mr. Chandler, I think that we think that there needs to be a process by which conformity with the desire of Congress is monitored. I think it is really up to this committee to determine what mechanism might most appropriately bring that about.

Mr. CHANDLER. Will Treasury provide us with suggestions of changes?

Mr. GIDEON. We would be happy to work with the committee if it felt that changes were appropriate.

Mr. CHANDLER. Because if we have here an exemption from Federal income taxes on income earned in Puerto Rico, and if there is a purpose for that and if that is to aid business development in Puerto Rico, then that is one thing.

But to require that some share of that then be lent to the rest of the CBI, to this member's view, is just an odd way of going about making a decision to benefit the rest of the Caribbean.

Perhaps we should take a look at that and separate the two.

You will not even smile let alone nod your head.

Mr. GIDEON. I think that we would be happy to cooperate with the subcommittee if it desired to make changes in that area, to give you what advice we could.

Mr. CHANDLER. Thank you, Mr. Chairman.

Chairman PICKLE. Well, Mr. Gideon, we thank you and we thank you particularly for your willingness to allow our staff people to come down to look at the record with respect to the involvement of other agencies, and also for your willingness to consider contacting some of these taxpayers about waivers.

We will be having other hearings. I thank you very much for your testimony.

[The following was subsequently received:]

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

June 19, 1990

RECEIVED
JUN 19 1990
Ways and Means
Subcommittee on Oversight

The Honorable J.J. Pickle
Chairman
Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives

Dear Congressman Pickle:

I wish to inform you that we have obtained the necessary consents to make public, if your Committee wishes, all or any portion of the information contained in the report we provided to you on May 11, 1990, describing the cases relating to the use of section 936 funds in qualified CBI countries.

Please let us know if we can be of further assistance.

Sincerely,

Kenneth W. Gideon

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

May 11, 1990

RECEIVED
MAY 14 1990
Ways and Means
Subcommittee on Oversight

The Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Pursuant to your letters dated April 18 and 26, 1990, and Chairman Rostenkowski's line of inquiry letter of January 25, 1989, I am providing you a report describing the cases we considered prior to the issuance of the temporary regulations under section 936(d)(4) of the Internal Revenue Code in September 1989. Because the information being provided is confidential return information subject to the disclosure limitations of the Internal Revenue Code, please keep the information confidential and subject to section 6103 restrictions until we obtain the necessary consents. As you know, we have already sent the requests to relevant parties for waivers of confidentiality, but it is difficult to determine at this time how long it will take to obtain the consents. We will inform you as soon as we get them. At that time, all or a portion of the information provided in the report may be publicly discussed. Until we obtain the consent of the taxpayers, this information may only be disseminated pursuant to the terms of 6103(f).

Also enclosed are the documents you requested in your letter of April 18 that pertain to the commitment of the Government of Puerto Rico made in 1985 when changes to section 936 were under consideration. In addition, if you desire, your staff may come and examine our files.

Please let us know if we can be of further assistance.

Sincerely,

Kenneth W. Gideon

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosures

The 936/CBI Program
Specific Transactions

Part I describes the seven projects which the IRS approved prior to the issuance of the temporary regulations under section 936(d)(4) in September 1989.* Of the seven cases, only three cases have been funded to date: the ABC Container transaction, the AT&T transaction, and the Air Jamaica transaction. Except for the CBI Fund transaction, which was presented under the private ruling process, all transactions were presented by Puerto Rican authorities under the government-to-government correspondence process. Copies of the no-objection letters issued for the seven transactions are attached.

Part II describes a project which involved a loan by the Government Development Bank of Puerto Rico (GDB) to the Central American Bank for Economic Development (CABEI). The IRS declined to issue a no-objection letter on that transaction. Part II also describes the types of transactions that were proposed but did not go beyond the planning stage after initial discussions with the IRS.

Part I:
Transactions For Which No-Objection Letters Were Issued

The CBI Fund ($60 Million)

In early 1988, First Boston proposed to organize a special investment vehicle, called the CBI Fund, in Puerto Rico to invest primarily in CBI countries. The CBI Fund would raise up to $60 million in 936 funds by issuing notes and shares of its capital stock. The Fund might seek a guarantee from the Overseas Private Investment Corporation (OPIC) for some of the notes.

This was the first project that was submitted to the IRS. The IRS issued a no-objection letter on August 3, 1988. The transaction, however, never materialized, presumably due to a lack of interest from 936 corporations.

A significant tax issue affecting this transaction concerned whether a guarantee of a 936 loan by a federal instrumentality, such as OPIC, jeopardizes the tax exempt status of the interest paid on the loan. The Internal Revenue Code rules governing the tax treatment of interest on municipal bonds prohibit a federal

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* FOMENTO has listed the Jamaican Housing Project as one of the CBI projects funded by 936 funds. FOMENTO did not submit a request to IRS to issue a no-objection letter on this project. We were informally informed by FOMENTO that the project involved the use of $8.7 million in 936 funds to construct low-cost prefabricated housing in Puerto Rico, which then was assembled in Jamaica.

agency from guaranteeing the obligation. The rational is that a double benefit -- in the form of a tax exemption and a federal guarantee -- would involve an excessive tax expenditure. The IRS ultimately concluded that the federal guarantee of 936 funds should be allowed because the purpose of the section 936/CBI program is sufficiently different from that of municipal bonds. Therefore, the temporary regulations issued under section 936(d)(4) do not prohibit such a guarantee.

ABC Container (Dominica), Ltd ($2.1 Million in Dominica)

This transaction involved the creation in Dominica of a manufacturing subsidiary of a Puerto Rican corporation, ABC Container. The subsidiary (ABC Container (Dominica), Ltd.) proposed to borrow $2.1 million in 936 funds to manufacture corrugated boxes in Dominica.

The request for a no-objection letter was submitted to the IRS on July 11, 1988. The letter was issued on August 9, 1988. This transaction was funded by Citibank. The Puerto Rican parent company, ABC Container, guaranteed the loan.

The Spanish Fort Free Zone ($7.59 Million in Jamaica)

This transaction involved the establishment of an industrial park in Jamaica. The use of $7.59 million in section 936 funds was approved, but the project was never funded. The request for approval was submitted to the IRS on July 11, 1988, and was approved on August 9, 1988.

Barbados Cable and Wireless Company ($10 Million in Barbados)

This transaction involved the use of $10 million in section 936 funds by the Barbados Cable and Wireless Company to upgrade telephone and telecommunications infrastructure and services in Barbados.

It was submitted to the IRS on July 11, 1988, for approval. The IRS issued a no-objection letter on August 9, 1988. This transaction has not yet closed. We were informally advised, however, that subsequent to the receipt of the no-objection letter, the transaction was revised to raise $13 million and that it is expected to close in the near future.

AT&T Fiber-Optic Lightguide Submarine Cable System ($17 million in Jamaica)

This transaction was submitted to the IRS in September 1988. The IRS had several discussions with the representatives of AT&T regarding the proper allocation of the project costs expended for the benefit of Puerto Rico and qualified CBI countries. The IRS issued a no-objection letter on April 26, 1989.

Description of the Transaction. AT&T obtained permission from the Federal Communications Commission on September 15, 1988,

to build a submarine cable system connecting Florida, Puerto Rico, the Dominican Republic, Jamaica, and Colombia. In order to finance the project, AT&T initially proposed to issue bonds through AFICA (Puerto Rico Industrial, Medical, and Environmental Pollution Control Facilities Financing Authority) to raise a total of $180 million in section 936 funds. The Service declined to issue a no-objection letter for two reasons. First, AT&T was issuing the bonds through AFICA, a conduit which was not liable on the bonds. To qualify for QPSII treatment, the interest must be sourced in Puerto Rico. If the bonds were issued by AT&T, the source of the interest paid by AT&T would have been in the United States. By having AFICA, a Puerto Rican institution, issue the bonds, AT&T claimed that the source of the interest was in Puerto Rico. Second, a cable system by nature benefits the jurisdictions at both ends. Therefore, only a half of the cost that is allocable to connecting two jurisdictions, one of which is a qualifying jurisdiction, should be eligible for section 936 financing. Based on the number of circuits in the cable system, the IRS determined that even if the transaction were restructured, of $180 million, not more than $80.2 million should qualify for section 936 financing -- $63.2 million allocable to Puerto Rico, and $17 million allocable to Jamaica. (At that time, only Puerto Rico and Jamaica were qualifying jurisdictions. Since then, the Dominican Republic has become a qualified CBI country.)

Subsequently, AT&T accepted the reallocation and revised the transaction. It proposed to raise $17 million from a financial institution in Puerto Rico. A no-objection letter was issued on that basis. The transaction has been funded.

Issues. Because the IRS suspected that AT&T might build the cable system regardless of whether it obtained 936 funds, it was initially concerned as to whether the transaction would be consistent with the goal of the section 936/CBI program. The IRS ultimately decided to issue a no-objection letter because the cable system was clearly a "development project" within even the most restrictive meaning of that term as used in section 936(d)(4) and also because it was administratively impossible to determine with any accuracy whether the project would have proceeded in the same form with alternative financing.

In addition, this project raised two other significant tax issues. As discussed above, one issue related to the source of the interest on the bonds when a conduit, such as AFICA, is used. The other issued related to the rules for determining the situs of an investment in the case of cables connecting two countries. The temporary regulations issued under section 936(d)(4) do not address the source of income when a conduit is used. Instead, the source of income is covered by the regulations under section 936(d)(2). We anticipate that regulations will be issued under section 936(d)(2) to provide that when a Puerto Rican conduit is used to raise 936 funds, income received from a non-CBI obligor, such AT&T, will not be sourced in Puerto Rico. As for the second issue, the temporary regulations under section 936(d)(4) provide

that, in the case of cables which are part of a communication system connecting two or more countries, only 50 percent of the portion of the facility that directly links the qualified CBI country to another country will be considered to be invested in the qualified CBI country.

Purchase of Two Aircraft by Air Jamaica ($51 Million)

General. The IRS received a submission on March 1, 1988, from FOMENTO to approve a transaction to finance the purchase of two aircraft by Air Jamaica. After several restructurings of the transaction to eliminate arbitrage possibilities, the Service issued a no-objection letter on December 7, 1988. Subsequently, Air Jamaica restructured the transaction again and resubmitted it to the IRS. The Service was told that the first transaction was not commercially feasible. The Service was also told informally that the GDB, which was to play the seminal role in the first transaction, had a new governor and that he decided to pull the GDB out of the transaction because the transaction might adversely affect the GDB's balance sheet.

The restructured transaction had to be changed several more times to eliminate the arbitrage potential. Meanwhile, FOMENTO talked to Congressman Rangel and the State Department to convince them of the importance and the merit of the transaction. As a result, Congressman Rangel sent the Treasury and the State Department letters (copy attached) urging the issuance of the no-objection letter. The staff of the Treasury also discussed the transaction with the staff of the State Department for Inter-American Affairs. The second no-objection letter was issued on April 28, 1989. FOMENTO asked for two more extensions to close the transaction. It finally closed in October, 1989.

Description of the Transaction. Air Jamaica initially proposed to borrow $88 million in section 936 funds to refinance its existing aircraft lease arrangements. This would not qualify for a no-objection letter because, contrary to the purpose of the CBI program, it involved a mere refinancing of existing assets.

Therefore, instead of refinancing its existing aircraft leasing arrangement, Air Jamaica decided to purchase two used Airbuses from Varig through a leasing company in Puerto Rico (ALG-Puerto Rico). The leasing company would purchase the aircraft for a total price of $57.5 million and lease them to Air Jamaica under an arrangement that will cause the lease to be treated as a sale for U.S. tax purposes. The leasing company would make a $5.75 million down payment. The balance ($51.75 million) would be paid at the time of delivery of the aircraft, on or about June 12, 1990.

The leasing company would issue bonds to raise $51 million in section 936 funds. The bonds would be guaranteed by American Express Bank Ltd., which is single A rated. Because 936 corporations wanted an AA rating, American Express would obtain a reconfirmation of its guarantee from Sanwa Bank. Of $51 million,

$5.75 million would be used to repay the leasing company for the down payment it made to Varig. The balance would be held in an escrow account until the delivery of the aircraft. Upon the delivery of the aircraft, which is expected in June, 1990, Varig would be paid the balance of the sales price ($51.75 million). It would be funded by the amount in the escrow account ($45.25 million), plus $1.75 million advanced by the leasing company, and $4.75 million paid by Air Jamaica.

Air Jamaica would make lease payments to the leasing company in an amount sufficient to cover interest on the bonds, plus administrative costs, plus amounts to be deposited in an escrow account as a sinking fund, plus compensation to the leasing company. The sinking fund account and the interest earned thereon would be used to pay principal on the bonds. Because of the arbitrage potential for funds held in the sinking fund and invested outside of Puerto Rico, we required that, except for the initial six months, funds be invested in eligible activities in Puerto Rico. Eligible activities generally mean activities that are determined by Puerto Rican authorities to be beneficial to the economic development of Puerto Rico and qualified CBI countries. The rate of return from investing in such eligible activities is more or less comparable to the interest rate on 936 funds. This requirement is the same as the one imposed by the regulations issued by the Commissioner of Financial Institutions in Puerto Rico.

Tax Issues. This transaction raised at least four significant tax issues: (1) the arbitrage of 936 funds; (2) the use of 936 funds for refinancing existing facilities; (3) the use of 936 funds for transactions involving sale and leaseback; (4) the situs of an investment in the case of a purchase of aircraft.

(1) Arbitrage. Generally, a borrower of 936 funds is engaged in arbitraging 936 funds if he does not use the funds promptly for investments in active business assets or developmental projects and, instead, invests the funds in obligations that yield higher interest than the interest he is required to pay on the 936 funds. Initially, the parties structuring the Air Jamaica transaction contemplated various ways to arbitrage 936 funds. For example, Air Jamaica would borrow 936 funds before it was required to pay Varig for airplanes and, instead, would invest the proceeds of the 936 loans in higher yielding guaranteed investment contracts. As discussed above, IRS minimized the arbitrage possibility by requiring Air Jamaica to invest only in eligible activities in Puerto Rico after the initial six months. This rule is reflected in temporary regulations section 1.936-10T(c)(6), which generally provides that the loan proceeds must be fully expended by the borrower within six months of the disbursement of the loan. For the initial six months, however, the loan proceeds may be invested at unrestricted yields in Puerto Rico or the country in which the investment is to be made. The six-month period may be extended for construction projects and long-term contracts for a reasonable period of time, but not more than three years. This

is consistent with the anti-arbitrage rules in the tax-exempt bond area.

(2) Refinancing. As discussed above, the original transaction contemplated by Air Jamaica was the refinancing of two airplanes it already operated. Refinancing does not generate any appreciable new assets in a CBI country. Therefore, the temporary regulations under section 936(d)(4) provide that 936 funds generally may not be used to refinance existing facilities.

(3) Sale and leaseback. Although the Air Jamaica transaction did not directly involve this issue, the Service considered whether a sale and leaseback transaction should be treated as an investment in an active business asset for purposes of section 936(d)(4). The Service concluded it should not, because a sale and leaseback transaction does not add new assets in a CBI country. Thus, the temporary regulations under section 936(d)(4) provide that an asset that is acquired and leased back to the person from whom acquired does not constitute an investment in an active business asset.

(4) Situs of an Investment. An issue arose as to how to determine where an investment is made when an airplane is purchased to be used in international traffic. The temporary regulations under section 936(d)(4) provide that aircraft will be considered an investment in a qualified CBI country in any year if it is used for transport to and from such country with some degree of frequency during that year and at least 50 percent of the income from the use of such aircraft for that year is sourced in that country.

Non-Tax Issues. In addition to the significant tax issues described above, this transaction raised various other concerns.

(1) The transaction involved the purchase of two Airbuses, which were made by a French concern, from Varig, a Brazilian airliner. After the no-objection letter was issued, the IRS learned that a Deputy Assistant Secretary for Aerospace at Commerce Department had some concern with the transaction, because the aircraft was neither U.S.-made nor bought from a U.S. concern. He originally requested a meeting with us but cancelled it for reasons unknown to us.* Section 936(d)(4) contains no requirement that 936 funds be used only to purchase U.S. made goods from U.S. concerns. Also, the savings from using 936 funds by Air Jamaica went to Air Jamaica, not to Airbus or Varig. Varig would have received the same amount of money from the sale of its Airbuses, regardless of whether Air Jamaica raised the funds in

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* A staff member at the State Department advised us that he had checked with Boeing to find out whether it objected to the transaction. According to him, Boeing was indifferent because the transaction involved used aircraft.

the 936 market or through conventional borrowing. Therefore, we believe that the purchase of Airbuses by Air Jamaica from Varig was consistent with the goal of the CBI program as described in the legislative history of section 936(d)(4).

(2) Although the benefit of 936 funds is supposedly a below-market interest rate, the overall cost to Air Jamaica was very high. According to financial schedules submitted to the IRS by the representatives of Air Jamaica, however, it was estimated that the present value of the savings from the use of 936 funds would be a little over $2 million. The Service was concerned that this saving was marginal relative to the size of the transaction. However, the existence of savings, coupled with the fact that Air Jamaica might not be able to access alternative sources of the fund, led the Service ultimately to approve the transaction. This financing cost must be considered in the context of the CBI market, particularly the creditworthiness of Air Jamaica. Neither Air Jamaica nor its owner, the Jamaican government, is rated a good credit risk.

(3) The Air Jamaica transaction did not appear to have created new employment in Jamaica. The IRS did not consider the creation of new jobs as an eligibility criterion. The reason was that although the creation of new jobs is an important objective, it should not necessarily be the only standard for measuring economic development, particulary in CBI countries. For example, privatizing nationalized industries in CBI countries is generally as beneficial to the economic development of a country due to the potential efficiency gains. It may, however, involve a reduction of the existing work force to achieve the greater efficiency.

Barbados Tenantry Road ($19 million in Barbados)

The project involved the construction and improvement of roads in Barbados that would facilitate the access of workers to existing sugar cane fields and the transport of sugar cane crops. Venezuelan government institutions would finance $28 million, and the Bardabos government would raise $9 million in 936 funds.

The IRS received the relevant information on July 28, 1989, and issued a no-objection letter on August 7, 1989. This transaction has not closed to date.

Part II:
Transactions For Which No-Objection Letters Were Denied

Loan by GDB to CABEI

Five Central American countries are members of the CABEI (Central American Bank for Economic Development). At present, none of the countries has a TIEA with the United States. In the summer of 1988, the GDB proposed to lend certain funds to CABEI, which would in turn on-lend the funds to financial intermediaries in the member countries. As soon as a particular country has a TIEA with the United States, the interest rate charged by the GDB

on the entire amount of loans made to that country would be adjusted retroactively to reflect the 936 interest rate. The IRS declined to issue a no-objection letter for two reasons. First, the adjustment effectively results in refinancing of existing facilities with 936 funds. (Please see the discussion relating to refinancing in connection with the Air Jamaica transaction discussed above.) Second, the transaction would have involved multiple non-Puerto Rican financial intermediaries.

It was argued that multiple non-Puerto Rican financial intermediaries should be allowed to disseminate 936 funds more easily in the local market. However, one of the goals of the CBI program is to make financing available to ultimate users of 936 funds at the lowest cost possible. If the ultimate borrower has to go through several layers of financial intermediaries to obtain 936 funds, much of the benefit of a reduced section 936 interest rate would not accrue to the ultimate borrower but, instead, to the intermediary institutions. Furthermore, while the Office of the Commissioner of Financial Institutions in Puerto Rico monitors, albeit indirectly, the interest rate charged by a Puerto Rican financial institution, there is no means to monitor the interest rate charged by non-Puerto Rican financial institutions. Also, because CBI countries are outside the U.S. audit jurisdiction, it is very difficult to monitor the use of 936 funds in the CBI context. A multiple layer of financial institutions outside the U.S. and Puerto Rican audit jurisdictions would exacerbate the difficulties.

However, in recognition of the fact that a financial intermediary in a CBI country indeed may be in a better position to reach the local market than a Puerto Rican financial institution, the temporary regulations permit one non-Puerto Rican financial intermediary. The temporary regulations require that financial institutions be no more than "reasonably compensated" for services performed and risks assumed. This rule was included for two reasons. First, while financial institutions need to be compensated for services performed, as stated earlier, the interest rate charged by non-Puerto Rican financial intermediaries cannot be monitored. Second, appropriate interest rates in various CBI countries would differ. The reasonable compensation standard recognizes the regional differences in interest rates, while preventing financial institutions from charging excessive fees for services.

Description of the Type of Disapproved Cases

Most of the cases that the IRS did not approve involved the arbitraging of 936 funds and did not go beyond the planning stage. For example, an investment banker would submit a proposal to us which would involve the issuance of 936 bonds for, say, $30 million, when only $10 million would be needed for a qualified project. The extra $20 million would be invested in higher yielding original issue discount obligations, such as guaranteed investment contracts and Eurobonds, until the section 936 obligation was due. By then, that $20 million would have grown to a sum which would be sufficient to pay off $30 million, plus accrued interest on the bonds so that the debt could be fully serviced without regard to the return on the CBI investment of $10 million.

Chairman PICKLE. Now, the next panel will be Mr. Antonio Colorado, who is secretary of state of the Commonwealth of Puerto Rico; and Mr. Jose Sosa, who is commissioner of financial institutions of the Commonwealth of Puerto Rico.

If those two gentlemen will take their positions?

The first witness will be Mr. Antonio J. Colorado, the secretary of state of the Commonwealth of Puerto Rico and then Mr. Sosa, you will follow.

We ask you to summarize your statement. We have your statement on file now, and your entire statement will be a part of the record in both instances. So if you will summarize within the 5 minutes, that will be greatly appreciated.

STATEMENT OF ANTONIO J. COLORADO, SECRETARY OF STATE, COMMONWEALTH OF PUERTO RICO

Mr. COLORADO. Thank you, very much, Mr. Chairman.

Mr. Chairman and members of the committee, I appear before this subcommittee to report on Puerto Rico's effort to promote Caribbean development and the investment of 936 funds in Caribbean Basin countries.

Section 936 was amended by the Tax Reform Act of 1986 to permit the investment of 936 funds in Caribbean countries which have signed tax information exchange agreements with the United States.

The primary purpose of this change was to promote economic development in qualified CBI countries by allowing 936 funds to be invested in active business and development projects therein. The 936 funds constitute assets of section 936 Puerto Rican and foreign corporations which are currently invested in Puerto Rico through financial institutions under the strict regulations of the Puerto Rico commissioner of financial institutions, as well as directly in investments which benefit Puerto Rico.

Section 936 companies account directly or indirectly for approximately one-third of Puerto Rico's total work force and about one-half of Puerto Rico's nongovernmental employment. Since 1986, after the tax reform was approved, our economy has experienced a revival of vigorous economic growth. Between fiscal year 1986 and fiscal year 1989, real gross national product in Puerto Rico grew at an annual compound rate of 4.8 percent. Between fiscal year 1986, and 1989 real growth fixed domestic investment grew at an annual compound rate of 19.4 percent. Total employment grew from an average of 777,000 jobs in fiscal year 1986 to 907,000 jobs for fiscal year 1989, for 5.3 percent per year. Manufacturing employment grew from 140,000 to 158,000 over the same period.

Developing and promoting investment in the Caribbean is not an easy task. Primarily because of the complexity of the different legal systems, country risks, compatibility risks, perception of political instabilities, heavy foreign debt, the shortage of experienced development institutions, the lack of clear policies towards investors, and investors' lack of information about development opportunities in Caribbean countries.

In relation to the use of 936 funds, we have experienced additional difficulties; such as the need for legislation and regulations.

There was a need to structure the concept, to establish the necessary procedures to implement the public policy of fostering the economic development of our Caribbean neighbors and to market the program so that we could raise interest from potential investor to establish the operations in qualified countries.

We created the Caribbean Development Office with the purpose of fostering the economic development of the region. Puerto Rico has aggressively promoted and marketed the Caribbean region in the mainland, in Europe and in the Far East.

Puerto Rico's FOMENTO, under took consistent and aggressive efforts to identify and promote worthwhile projects in qualified countries.

Prior to the recent issuance of proposed and temporary regulations, the approval process was lower because there were no guidelines as to what constituted active business assets or development projects in qualified countries. And funds could not be invested without prior service approval on a case-by-case basis.

The possibility of facilitating the use of 936 funds was significantly restricted by the requirement that in order to be eligible for 936 funds use, the Caribbean countries must have signed a tax information exchange agreement with the United States.

Although we agree with this policy, the fact is that this requirement imposed by the act of 1986, restricted Puerto Rico's ability to channel section 936 funds to only two Caribbean countries at the time, Barbados and Jamaica. Of the six countries which have signed tax information exchange agreements with the United States, two of them, the largest countries, have been enacted only within the last 6 months.

Puerto Rico has played a substantial role in the adoption of tax information exchange agreements between the United States and the Caribbean countries.

The tax information exchange agreement, as I said before, exists now with Barbados, Dominica, the Dominican Republic, Grenada and Jamaica. The Virgin Islands can also use the funds.

Despite the complexities of the legislative framework and the delays in the issuance of the regulations, we are pleased to report today that the Commonwealth of Puerto Rico has promoted 80 projects in the Caribbean that are generating nearly 14,000 jobs, and over $386 million in investments which include $306.2 million in section 936 funds.

Of the total amount, over $200 million have already been dispersed. More than two-thirds of 936 loans have been approved recently due to the fact that the Dominican Republic and Trinidad/Tobago became eligible to receive such funds during the last 6 months.

Thank you, very much, Mr. Chairman.

[The statement of Mr. Colorado follows:]

TESTIMONY OF THE HONORABLE ANTONIO J. COLORADO
SECRETARY OF STATE
COMMONWEALTH OF PUERTO RICO

PRESENTED BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
OF THE HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

April 3, 1990

I. INTRODUCTION

Mr. Chairman and Members of the Committee, it is my pleasure to appear before this Subcommittee to report on Puerto Rico's efforts to promote Caribbean regional development, including the investment of section 936[1] funds in active business assets and development projects in qualified Caribbean Basin countries. Also appearing with me is the Honorable Jose A. Sosa, Puerto Rico Commissioner of Financial Institutions.

As you know, section 936 and its predecessor provisions have been the key to Puerto Rico's economic development. Over the past 40 years, the development of the Puerto Rico economy from an agricultural economy to an economy based on services and manufacturing has often been referred to as an "economic miracle." Puerto Rico GNP increased at an average annual rate of 5.3% in the 1950s and 7% in the 1960s, compared to U.S. average annual growth in this period of 3.7%.[2] While the Puerto Rico economy was relatively stagnant during the period 1970-1986, it has been very strong since 1986. Real GNP grew by 3.0% in 1985, 2.5% in 1986, 4.8% in 1987, 4.6% in 1988, and 3.6% in 1989.[3] This record of economic accomplishment is attributable primarily to the existence of section 936 and its predecessor provisions, which permit manufacturing and service enterprises to conduct business in a U.S. possession without U.S. taxation, in

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[1] Unless otherwise specified, all section references are to the Internal Revenue Code, as amended (the "Code"), and to the Treasury regulations promulgated thereunder.

[2] See The Operation and Effect of the Possessions Corporation System of Taxation, Sixth Report, Department of the Treasury, Chapter 3 (March 1989) (referred to hereafter as "Sixth Report").

[3] Source: Puerto Rico Planning Board, Economic Report to the Governor, Statistical Appendix (1989).

combination with the carefully conceived Industrial Incentive Act provisions enacted by the Government of Puerto Rico.

Section 936 was amended by the Tax Reform Act of 1986 (the "Act") to permit the tax-free investment of funds by section 936 corporations in projects in Caribbean countries which have signed tax information exchange agreements ("TIEAs") with the United States (i.e., "qualified countries"). The primary purpose of this legislative change was to promote economic development in qualified countries in the Caribbean region by allowing section 936 funds to be invested in active business and development projects in qualified Caribbean countries.[4]

Section 936 funds constitute assets of section 936 corporations, Puerto Rican and foreign, which are currently invested in Puerto Rico through financial institutions under the strict regulation of the Puerto Rico Commissioner of Financial Institutions, as well as directly in investments which benefit Puerto Rico.

Puerto Rico's economy derives major benefits from the manufacturing and service activities of section 936 corporations. To illustrate the enormous significance of the manufacturing sector to the overall economy of Puerto Rico, a four percent reduction in Puerto Rico's gross product in manufacturing would be the equivalent of eliminating all agricultural production in Puerto Rico. An eleven percent reduction in manufacturing would be equivalent to eliminating all tourism in Puerto Rico.

Section 936 companies account directly and indirectly for approximately one-third of Puerto Rico's total workforce and about one-half of Puerto Rico's non-governmental employment. Section 936 and its predecessor transformed Puerto Rico in the past 40 years into the strongest economy in the Caribbean.

In addition, section 936 funds on deposit with Puerto Rico financial institutions have a significant beneficial effect on every aspect of our economy. According to the U.S. Treasury, the cost of capital in Puerto Rico could be 1.0 to 1.5 percentage points below world rates, due to the availability of section 936 funds.

Since the amendments to section 936 in 1986 brought about renewed investor confidence in Puerto Rico, our economy has experienced a revival of vigorous economic growth. Between FY 1986 (ending June 30) and FY 1989, real GNP in Puerto Rico grew at an annual compound rate of 4.3 percent. Between FY 1986 and FY 1989, real gross fixed domestic investment grew at an annual

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[4] Staff of the Joint Comm. on Tax'n, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 1002 (Comm. Print 1987).

compound rate of 19.4 percent. Total employment grew from an average of 777,000 jobs in FY 1986 to 907,000 for FY 1989, or 5.3 percent per year. Manufacturing employment grew from 140,000 to 158,000 over the same period.

Developing and promoting investment in the Caribbean is not an easy task, primarily because of the complexity of the different legal systems, country risks, convertibility risks, perceptions of political instabilities, heavy foreign debt, the shortage of experienced development institutions, the lack of clear policies towards investors, and investor's lack of information about development opportunities in qualified Caribbean countries.

In relation to the use of section 936 funds, we have experienced additional difficulties, such as the need for legislation and regulations, from both Puerto Rico and the federal government. There was a need to structure the concept, to establish the necessary procedures to implement the public policy of fostering the economic development of our Caribbean neighbors, and to market the program, so that we could raise interest from potential investors to establish their operations in qualified countries. Puerto Rico created the Caribbean Development Office in the Economic Development Administration with the purpose of fostering the economic development of the region.

The Commonwealth of Puerto Rico has aggressively promoted and marketed the Caribbean Region in the mainland, in Europe and in the Far East. We also have worked with our Caribbean neighbors to establish new transportation linkages for the region and have become a major force in the transfer of technology to our neighbors.

In addition, the government of Puerto Rico has established a scholarship program which offers full scholarships to students from the region to study in universities and vocational schools in Puerto Rico. Moreover, we continue to provide technical assistance through our Point Four Program to countries in the region.

To effectively pursue the government's public policy of fostering the economic development of our Caribbean neighbors, Puerto Rico's Economic Development Administration ("Fomento") undertook consistent and aggressive efforts to identify and promote worthwhile projects in qualified countries. To this effect, we worked closely with the U.S. Department of Treasury in designing the approval process for the projects that were submitted for consideration.

Prior to the issuance of proposed and temporary regulations (the "Regulations") interpreting section 936(d)(4) by the Internal Revenue Service (the "Service") in September 1989,

the approval process was slower because there were no guidelines as to what constituted "active business assets" or "development projects" in qualified countries. Section 936 funds could not be invested in qualified projects in qualified countries without prior Service approval on a case by case basis.

Furthermore, the possibility of fostering and facilitating the use of section 936 funds for the economic development of the Caribbean region was significantly restricted by the requirement in the Act that, in order to be eligible for section 936 funds, the Caribbean countries must have signed a TIEA with the United States.

Because the opportunities for financing projects with section 936 funds are so attractive, an incentive is created for Caribbean countries to sign a TIEA with the United States. TIEAs benefit the United States by providing a full exchange of tax information between the signatory countries and by providing a law enforcement tool against tax evasion and money laundering.

Although the Government of Puerto Rico empathizes with the U.S. policy of having Caribbean countries sign TIEAs, the fact is that this requirement imposed by the Act in 1986 restricted Puerto Rico's ability to channel section 936 funds to only two Caribbean countries at that time: Barbados and Jamaica. Of the six countries which have a TIEA with the United States, two of them enacted the agreement only in the last six months.

Puerto Rico has played a substantial role in the adoption of TIEAs between the United States and Caribbean countries, and will continue to work with the governments of the regions and the U.S. government for this purpose as part of its commitment to facilitate the investment of section 936 funds in the Caribbean.

TIEAs currently exist with Barbados[5]; Dominica[6], the Dominican Republic[7], Grenada[8], Jamaica[9], and Trinidad and Tobago[10]. A TIEA has been signed with Costa Rica and its ratification is anticipated. In addition, a TIEA is expected to come into force in the near future with St. Lucia.

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[5] TIEA was effective November 3, 1984.

[6] TIEA was effective May 9, 1988.

[7] TIEA was effective October 13, 1989.

[8] TIEA was effective July 13, 1987.

[9] TIEA was effective December 18, 1986.

[10] TIEA was effective February 9, 1990.

Despite the complexities of the legislative framework and the delays in the issuance of the Regulations, we are to report today that the Commonwealth of Puerto Rico has promoted 80 projects in the Caribbean that are generating nearly 14,000 jobs and over $386 million in investments, which include $306.2 million in section 936 funds. Of the total amount, over $200 million have already been disbursed. More than two-thirds of the section 936 loans have been approved recently due to the fact that the Dominican Republic and Trinidad and Tobago became eligible to receive such funds during the last six months.

An important factor which has facilitated the recent flow of section 936 funds to countries of the Caribbean Basin is the issuance of the Regulations in September of 1989. The Regulations provide important guidelines which now enable section 936 funds to be invested in qualified projects in qualified Caribbean countries without prior Service approval. Increased investment of section 936 funds in the Caribbean will create even stronger incentives for other Caribbean countries to enter into TIEAs with the United States. However, we believe that improvements could be made to the section 936 program in the Caribbean through refinements in the Regulations in order to better facilitate section 936 investment in the Caribbean Basin.

II. DISCUSSION

A. 1986 Enactment of Section 936(d)(4)

The Act amended section 936 in order to make the provision more cost efficient from a U.S. Treasury perspective.[11] Most importantly, section 936(d)(4) was enacted in order to permit the investment of section 936 funds in qualified Caribbean countries for economic development.

Section 936(d)(4) expanded the definition of qualified possession source investment income ("QPSII") that a section 936 corporation may receive without U.S. tax to include income derived from loans made by qualified financial institutions for the acquisition or construction of active business assets or development projects in qualified Caribbean countries (i.e., those countries which have signed a TIEA with the United States). Thus, income received by section 936 corporations from the

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[11] Among the amendments made in 1986 were adjustments to the cost sharing and profit split methods of allocation of income from intangibles, allowance of the section 936 credit for qualified active business income even though payment is received in the United States, an increase in the percentage of income required to be derived by section 936 corporations in an active trade or business within a possession, and the inclusion of the U.S. Virgin Islands within the scope of section 936.

investment of section 936 funds in financial institutions which loan such funds for qualified investments is treated as income from an investment in a U.S. possession "for use therein" and, therefore, eligible for the section 936 credit.

An economically strong Caribbean is crucial to maintaining the stability of the region and clearly of great importance to the United States. Puerto Rico imports seven times per capita more from Caribbean countries than from the United States. Non-traditional Caribbean exports to Puerto Rico have grown twice as fast as such exports to the United States since 1984. The use of section 936 funds outside Puerto Rico allows for a similar strengthening of the economies of the countries of the Caribbean.

In 1983 Congress enacted the Caribbean Basin Initiative ("CBI") without investment incentives that would stimulate the creation of business enterprises in the Caribbean to take advantage of the opportunity to access the U.S. market. In effect, no funding was provided for the CBI. To stimulate investment in CBI eligible nations, Congress determined in 1986 that section 936 funds should be used to finance active business assets and development projects in those Caribbean countries which have signed and ratified TIEAs with the United States by making available tax-exempt section 936 funds for qualified projects.

Section 936 permits the funding of the CBI through the free market financial system, not through a direct government subsidy program. Thus, through the extension of section 936 investment provisions to the CBI, section 936 funds are now flowing in furtherance of U.S. policy as approved by Congress in the 1983 CBI legislation. With the current focus on U.S. aid to Eastern Europe, Panama and Nicaragua, the need for the continued flow of private funds to CBI investments is even more critical.

As part of the legislative process that culminated in the Act, the Government of Puerto Rico agreed to make a good faith effort to promote $100 million of annual CBI investment.[12]

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[12] In a November 14, 1985 draft "Memorandum of Agreement", Puerto Rico proposed the retention of pre-1986 Act section 936 in return for Puerto Rico's guarantee of $100 million of annual CBI investment. Although this Agreement was never adopted, the Conference Report to the 1986 Act noted that Puerto Rico would make a good faith effort to promote $100 million of annual CBI investment. Moreover, language in The General Explanation of the Tax Reform Act of 1986 which indicates that Puerto Rico is required to guarantee $100 million of annual investments was clarified in a May 27, 1987 letter from David Brockway, Chief of Staff of the Joint Committee on Taxation, to Congressman Charles

Despite the limited number of countries that have signed TIEAs, the complexity of the legislative framework and the delay in the issuance of the Regulations, Puerto Rico's efforts and achievements clearly demonstrate much more than a good faith effort in furthering economic activities in the Caribbean which foster income, production and employment in the region. To date, section 936 investments have taken place in a number of qualified CBI countries, providing important economic benefits in furtherance of U.S. policy (See Appendix).

Puerto Rico has always granted high priority to the use of section 936 funds in the CBI. It is for this reason that Puerto Rico promptly adopted a special regulation (Regulation 3703) to facilitate the flow of funds to the Caribbean. Additional proof of our commitment to aid this flow of funds is our willingness to forego direct benefits to our government and to Puerto Rico's economy in general, benefits that are generated by investment and other regulatory requirements, which under Regulation 3582 are made inapplicable to CBI loans. In fact, no other eligible activity in Puerto Rico is granted such preferential treatment.

In addition to these regulatory benefits, CBI loans are favored by an expedited review and approval process which grants priority to Caribbean projects.[13] This process has been the result of a joint effort between Fomento and the Office of the Commissioner of Financial Institutions, in which the former assesses the economic impact of the project in Puerto Rico and the latter evaluates compliance with the local regulations.

Fomento's economic impact assessment assures that projects do not:

(a) adversely affect the economy of Puerto Rico through the loss of jobs or the idling of plans and equipment; and

(b) create an adverse impact upon the economy of Puerto Rico through the outflow of section 936 funds based on availability of these funds in the Puerto Rican financial market.

As of now, no project presented to Fomento has failed to qualify for Fomento's endorsement.

B. Rangel in which Puerto Rico's commitment to carry out a good faith effort toward the $100 million annual goal was again noted.

[13] Section 936(d)(4) of the Code requires the approval by the Puerto Rico Commissioner of Financial Institutions of all section 936 projects in the Caribbean Basin. In addition, Section 5.1.3. of Puerto Rico Regulation 3703 requires that all such projects receive the written endorsement of Fomento.

In 1989, Air Jamaica borrowed $51 million in section 936 funds to modernize its fleet with the purchase of two additional aircraft. The transaction utilized a Puerto Rico subsidiary of a U.S. aircraft leasing corporation as an "eligible similar institution" which issued bonds secured by a letter of credit. The proceeds of the bond offering are being used to purchase the two aircraft for Air Jamaica. This significant transaction improves transportation to Jamaica, which benefits Jamaica's tourism and commerce.

Several other projects have taken place in Jamaica utilizing section 936 funds. A project that will improve the infrastructure of Jamaica and the entire region is AT&T's $180 million fiber optic submarine telephone cable system which links the United States with the Caribbean and Latin America. The Jamaican portion of the cable, costing $17 million, was financed with section 936 funds. In addition, low-income housing was facilitated in Jamaica utilizing $8.7 million in section 936 funds.

The renovation of the Rose Hall Beach and Country Club in Montego Bay, Jamaica by Rose Hall Associates Limited Partnership with $6 million of section 936 funds will also help Jamaica's tourist business. Unfortunately the acquisition of the hotel, which was purchased under the government of Jamaica's privatization program, was not eligible for section 936 financing because the Regulations at present do not allow such financing.

In the Dominican Republic $18 million of section 936 funds are being utilized for the construction of a barge to be equipped with a 40 megawatt electricity plant to be owned by Seaboard Overseas, Ltd. which will produce energy for sale to the Dominican Electric Company.

In Dominica, a cardboard box factory which services that Country's important banana industry and its manufacturing sector has been established by ABC Container Company utilizing $2.1 million in section 936 funding.

Additional investments of $203.4 million in section 936 funds for qualified CBI projects in Barbados, the Dominican Republic, Trinidad and Tobago, and the U.S. Virgin Islands have already been approved.

B. The Regulations Implementing Section 936(d)(4)

The Government of Puerto Rico has worked with the U.S. Treasury Department and the Service from the inception of the efforts to implement section 936(d)(4). We provided comments to the Treasury Department on the November 15, 1988 draft of the Regulations on December 15, 1988 and on April 25, 1989. In addition, comments on the recently issued Regulations were

submitted by the Government of Puerto Rico on December 19, 1989, and testimony was presented before the Service at the public hearing on the Regulations held March 19, 1990.

We appreciate the efforts of the Treasury Department and the Service in issuing these Regulations. Transactions may now proceed by following the Regulations without going through the cumbersome process of obtaining prior Service and Treasury approvals on a case by case basis.

The Regulations, however, are too rigid in defining eligible projects and, unless amended, will inhibit CBI investment. The Regulations must provide for the utilization of section 936 funds to finance the transfer of assets from the public sector to the private sector (i.e., "privatization"). This issue is reserved in the Regulations. Thus, currently section 936 funds may not be used for privatization, a type of transaction that is very important for the Caribbean region. For example, the purchase of the Rose Hall Beach and Country Club Hotel from the Government of Jamaica noted above should have been eligible for section 936 financing, but was not.

We understand that privatization is a key U.S. policy objective promoted by the U.S. Department of State, the Agency for International Development, the Overseas Private Investment Corporation, as well as the Treasury Department itself. It is critical, therefore, that the Regulations address privatization and provide that such transactions may qualify for the use of section 936 funds when established requirements are met.

In order to obtain the efficient flow of funds to CBI projects in diverse jurisdictions with disparate legal systems and credit risks, the Regulations must allow for the transferability of funds from Puerto Rico financial institutions to regional banks that can appropriately identify and monitor eligible projects. Frequently, expertise necessary for an economically successful transaction will be found both in a regional bank, such as the Central American Bank for Economic Integration, and a local institution with knowledge of the local economy and credit market. The Regulations should not impede such structures by arbitrarily permitting only one non-Puerto Rico financial intermediary.

Under the Regulations, the returns to qualified financial institutions and financial intermediaries are restricted. No governmental regulation of profit spreads is necessary or appropriate. Financial institutions will be competing aggressively for CBI business. The borrower will always seek the least expensive loan, and the transactions will be structured to minimize transaction costs, intermediary spreads, and, indeed, intermediary institutions not essential to the financing. Nothing in the legislative history suggests that

the CBI lending program is to go forward only with a state-regulated return to the participants.

The Regulations limit the definition of qualified investments to "loans." Other forms of investments, such as equity participations, joint ventures, or stock positions are not allowed. The Regulations should be structured to accommodate other types of investments which are clearly within the scope of the statutory language and should permit debt/equity swaps. In the Caribbean region, where equity funds are scarce and debt/equity swaps are common financial events, the Regulations should encourage rather than discourage such transactions.

The Regulations must allow for the qualification of special purpose entities as "qualified financial institutions." Special purpose subsidiaries of banks and non-banks are eligible to participate in the section 936 funds market under Regulation 3582. Special purpose subsidiaries were clearly envisioned in the letter from Assistant Secretary Chapoton to the Honorable Charles B. Rangel, dated August 24, 1988. In addition, the newly created Caribbean Basin Projects Financing Authority should be included in the definition of a qualified financial institution.

The Regulations limit the types of assets which are considered qualified for CBI investments. The acquisition of real property or raw land is not included in the definition of an investment in active business assets; only amounts attributable to capital improvements or upgrading of such qualified assets qualify under the Regulations. Land acquisitions should clearly qualify if some construction or rehabilitation is involved, particularly in light of the need to facilitate rebuilding after the devastation of Hurricane Hugo. We are unaware of any legislative history, other authority or tax policy principles that support the exclusion of land from CBI financing.[14]

Personal property which at any time during the five year period preceding the date of acquisition was used in a business activity in the qualified Caribbean Basin country does not qualify for section 936 financing under the Regulations. Tangible personal property should not be removed from the definition of qualified assets merely because it has been previously used in a qualified business activity in the qualified Caribbean Basin country.

Furthermore, the Regulations provide additional limitations with respect to the type and amount of incidental expenditures which may be made in a qualified investment. For

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[14] Ruling authority is provided to qualify property other than real property as a qualified asset. At a minimum, the acquisition of real property should be allowed under the ruling process.

example, the Regulations should not limit the amount of issuance costs includable in the financing to an amount equal to two percent of the proceeds of the issuance. Financing businesses in an underdeveloped part of the world is novel, difficult, risky, and therefore costly. If these costs cannot be financed, a barrier to participation in this important source of financing is erected for the less creditworthy borrowers in the Caribbean region. The Regulations should allow refinancing incidental to investment in active business assets in excess of the current five percent limit if bona fide business reasons so necessitate and if a private ruling is obtained.

The General Explanation of the Act explicitly provides that "[a]ctive business assets generally mean plant, equipment, and inventory associated with a manufacturing operation" (emphasis added).[15] While the Regulations do provide for the financing of "working capital" not in excess of ten percent of the otherwise qualifying investment in active business assets, the ten percent limitation is arbitrary and inconsistent with this legislative history. The Regulations should state explicitly that the financing of inventory and receivables, in connection with the financing of a plant, is expressly sanctioned. This would allow the utilization of section 936 funds for export financing, an important mechanism to foster economic growth in the Caribbean. Moreover, the Regulations should allow other working capital needs to be financed if a private ruling is obtained.

Other technical comments are included in my testimony presented to the Service on March 19, 1990, which has been made available to your staffs.

In summary, the Regulations provide much needed guidance to facilitate the flow of section 936 funds into the CBI. Nevertheless, key issues such as privatization, the free transferability of section 936 funds among financial intermediaries, the ability to invest bond proceeds, and other burdensome restrictions on the mechanics of qualified investments remain to be resolved. It is of critical importance that these issues be answered in a manner which allows for maximum flexibility with respect to CBI investments in recognition of the unique needs of the Caribbean Basin.

III. SUMMARY

It is our desire to urge that our joint regulatory frameworks operate efficiently to channel eligible funds into the Caribbean economy to promote regional economic development. This requires the adoption of simpler and more flexible regulations that aid and not encumber the flow of section 936 funds.

The Regulations have provided useful guidelines which better facilitate the flow of section 936 funds to CBI investments. Nevertheless, greater investment of section 936 funds in the Caribbean Basin will be made possible if our recommendations to amend the Regulations are followed.

Thank you, Mr. Chairman. I would be pleased to answer questions.

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[15] Staff of the Joint Comm. on Tax'n, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 1005 (Comm. Print 1987).

APRIL 3, 1990

APPENDIX

DESCRIPTION OF SECTION 936 CARIBBEAN BASIN PROJECTS

ABC Container (Dominica), Ltd. (Dominica)

ABC Container has been supplying quality corrugated boxes to the Puerto Rican industrial community for over 30 years. Following participation in Fomento's investment mission to Dominica in 1987, ABC Container used section 936 funds to establish a box factory in Dominica, operational in April 1989. This factory provides carton containers to Dominica's banana industry, which accounts for 95 percent of Dominica's exports, as well as to other local industries. By providing a domestic source of boxes, ABC Container facilitates Dominica's agricultural exports and provides a valuable support service to the growing manufacturing sector. The availability of section 936 funds made this project more attractive for ABC Container.

Section 936 Funds:	$2.1 million
Borrower:	ABC Container (Dominica), Ltd.
Lender:	Citibank, N.A.
Credit Enhancement:	Puerto Rico Container Company
Terms:	10 years at below prime rate
Jobs Created:	27 construction-related jobs; 50 permanent jobs
Disbursed:	August 1988

Seaboard Overseas, Ltd., Energy Project (Dominican Republic)

Transcaribbean Capital Corporation (a subsidiary of Seaboard Overseas, Ltd.) borrowed section 936 funds to acquire a barge equipped with a 40 megawatt electricity plant in order to produce energy for the Dominican Republic. This project helps alleviate the shortage of electrical power in the Dominican Republic. The use of section 936 funds made the project more attractive to Seaboard Overseas.

Section 936 Funds:	$18 million
Borrower:	Transcaribbean Capital Corporation
Lender:	Chase Manhattan Bank, N.A.
Credit Enhancement:	Seaboard Overseas, Ltd.
Terms:	8 years at below prime rate
Disbursed:	January 19, 1990

Jamaica Housing Project (Jamaica)

In this first project in the Caribbean Basin to access section 936 funds, 754 low-cost prefabricated housing units were constructed in Puerto Rico and assembled in Jamaica to provide low-income housing. The Government of Jamaica's Urban Development Corporation was having difficulty finding long-term financing for this project. The section 936 loan enabled the Jamaican government to address critical housing needs and, at the same time, save hard currency by obtaining an interest rate more attractive than conventional financing.

Section 936 Funds:	$8.7 million
Borrower:	Government of Jamaica
Lender:	Government Development Bank of Puerto Rico ("GDB") and the Puerto Rico Industrial Development Company ("PRIDCO")
Credit Enhancement:	Bank of Credit and Commerce International
Terms:	$7.5 million loaned by the GDB for 16-1/2 years at 8%; $1.2 million loaned by PRIDCO for 10 years at 8-1/2%
Jobs Created:	200 temporary jobs created in Jamaica during the construction phase
Disbursed:	October 1987

Air Jamaica (Jamaica)

Air Jamaica has utilized finance leases to acquire two Airbus A300-B4s from Aviation Leasing Group in Puerto Rico with the help of $51 million in section 936 funds. The lower interest rate obtained with section 936 funds saves the Government of Jamaica hard currency and increases Air Jamaica's cash flow. The smaller debt burden due to the use of section 936 funds also made it easier for the project to obtain credit enhancement.

Section 936 Funds:	$51 million
Borrower:	Aviation Leasing Group, Puerto Rico, Inc.
Lender:	$51 million in notes were issued to section 936 corporations in four series, underwritten by Drexel Burnham Lambert
Credit Enhancement:	American Express Bank and Sanwa Bank of Japan

Terms:	5 to 11 years at 81 to 88% of 90-day Libor floating rate
Disbursed:	August 28, 1989

AT&T Fiber Optic Transcaribbean Cable (Jamaica)

American Telephone and Telegraph Co. is currently constructing a $180 million digital fiber-optic lightguide submarine cable system connecting the Caribbean region to the North and South American continents. Jamaica's portion of the cost of the cable, $17 million, qualified for section 936 financing.

Section 936 Funds:	$17 million
Borrower:	American Telephone and Telegraph Co.
Lender:	Chase Manhattan Bank, N.A.
Terms:	5 years, renewable for an additional 5 years
Disbursed:	July 1989

Rose Hall Beach and Country Club (Jamaica)

The Rose Hall Associates Limited Partnership has purchased a hotel in Montego Bay from the Jamaican government. Section 936 funds could not be utilized for the purchase of the hotel because the section 936(d)(4) temporary regulations issued by the U.S. Treasury do not allow lending for privatizations. Section 936 funds, however, are being used to refurbish the hotel.

Section 936 Funds:	$6 million
Borrower:	Rose Hall Associates Limited Partnership
Lender:	Chase Manhattan Bank, N.A.
Credit Enhancement:	Overseas Private Investment Corporation ("OPIC")
Terms:	5 years, at a floating rate below Libor
Disbursed:	March 1990

***Abbott Laboratories (Dominican Republic)**

Abbott Laboratories has announced plans to use $4.5 million in section 936 funds to construct a twin plant in the Dominican Republic. This plant will produce intravenous solutions and will employ 200 people in the Dominican Republic.

Section 936 Funds:	$4.5 million
Borrower:	Abbott Laboratories
Lender:	Not Yet Determined
Jobs Created:	200
Expected Disbursement:	1990

31-742 O - 90 - 4

***Barbados Telephone Company (Barbados)**

The Barbados Telephone Company, owned by Cable & Wireless and the Government of Barbados, will use section 936 funds to modernize telecommunications infrastructure in Barbados. Low interest section 936 funds will save the Government of Barbados hard currency as well as improve the cash flow of the Barbados Telephone Co.

Section 936 Funds:	$13 million
Borrower:	Barbados Telephone Company
Lender:	Scotia Bank of Puerto Rico
Credit Enhancement:	Cable & Wireless
Terms:	Up to 5 years at below prime rate
Expected Disbursement:	April 1990

***Caribbean Methanol Company (Trinidad & Tobago)**

Caribbean Methanol Co., a joint venture between a Trinidad life insurance company and several international engineering firms, will use section 936 funds to construct Trinidad's second methanol plant. The project will be a major boost to the country's petrochemical industry. The use of section 936 funds will increase the Caribbean Methanol Company's cash flow during the project start up.

Section 936 Funds:	$79 million
Borrower:	Caribbean Methanol Company
Lender:	Citibank, N.A.
Credit Enhancement:	OPIC insurance
Terms:	8 years
Jobs Created:	80
Expected Disbursement:	May 1990

***Phoenix Park (Trinidad & Tobago)**

This joint venture between the Trinidad government and a private company will borrow section 936 funds to build a facility to separate butane and methane from natural gas.

Section 936 Funds:	$66.5 million
Borrower:	Phoenix Park
Lender:	Citibank, N.A.
Credit Enhancement:	Provided by Dupont during construction phase
Terms:	9 years
Jobs Created:	50
Expected Disbursement:	April 1990

*TT-PD-040

Section 936 Funds: $31.4 million

Details on this project are confidential at the request of the investor until the financial transaction is closed.

*UV-PD-004

Section 936 Funds: $9 million

Details on this project are confidential at the request of the investor until the financial transaction is closed.

Total: $306.2 million

* Denotes projects approved by the Commissioner of Financial Institutions and the Administrator of Fomento for which funds have not yet been disbursed.

Chairman PICKLE. Thank you, very much, Mr. Colorado.
Mr. Sosa, you may speak.

STATEMENT OF JOSE A. SOSA, COMMISSIONER OF FINANCIAL INSTITUTIONS, COMMONWEALTH OF PUERTO RICO

Mr. SOSA. Thank you, Mr. Chairman.

Mr. Chairman, in order to summarize my testimony, I will specifically answer 10 questions that were posed to our office in the committee's invitation.

The questions are the following:

First, what is the total amount of section 936 funds currently invested in Puerto Rico? Second, how much of this sum is held by financial institutions and how much is directly invested?

As of February 1990, there were about $9.4 billion of eligible or 936 funds invested in eligible institutions. The monthly reports submitted to our office by these institutions do not cover direct investment of 936 companies. Nevertheless, our estimates indicate that approximately $4 to $5 billion are invested directly by the companies.

Third, what institutions or types of institutions hold section 936 funds? Eligible institutions, which are depository or similar financial institutions expressly authorized to receive 936 funds and subject to the regulatory requirements of regulation 3582, are allowed to receive these funds.

Presently 35 commercial banks, savings and loan institutions and brokers are licensed as such in Puerto Rico.

Fourth, what is the amount of section 936 funds held by the Government Development Bank?

Under local regulation 3582, 15 percent of the funds received by eligible financial institutions must be invested in loans to the Puerto Rico government, other government obligations, certain interim construction loans originated by savings and loan institutions, or deposited with the Government Development Bank (GDB).

Presently said requirement amounts to approximately $1 billion of which only $284.5 million are deposited with the Government Development Bank. As you can see, over 72 percent of this requirement is complied with by direct investments and not with deposits in the Government Development Bank.

Fifth, what efforts has the Government Development Bank made to make loans of section 936 funds?

Currently the GDB has extended over $1.3 billion in eligible loans to both the public and private sector. As you may see, the GDB's portfolio of eligible loans far exceeds the amount of eligible funds received by it. The actual ratio is $4.70 lent for every dollar received.

Therefore, contrary to the belief of some, not 1 cent of eligible funds sits idly in the GDB.

Sixth, what restrictions are there on the use, by the GDB of section 936 funds for loans to eligible CBI countries?

In addition to restrictions imposed on it by virtue of its legislative charter, the GDB's CBI lending activity is subject to the requirements of regulations 3582 and 3703, and the Federal tempo-

rary regulations. In other words, the GDB is on the same footing as private eligible institutions.

Seventh, how will your office oversee loans of section 936 funds in eligible CBI countries to assure that they are in compliance with statutory and regulatory requirements?

Our office currently overviews compliance with its statutory and regulatory requirements applicable to the 936 market. This supervisory role comprises the broad spectrum of administrative actions and authority and has been highly effective in assuring the due use of the funds in Puerto Rico. This same supervisory structure is equally applicable to CBI loans with the added safeguard that all CBI projects must be approved by the commissioner prior to the disbursement of funds.

We understand that the present supervisory framework effectively assures statutory and regulatory compliance in the 936 market in general and in the CBI.

Eighth, what problems have you observed in the operation of the 936/CBI loan program?

First, the very limited number of countries that had initially signed tax information exchange agreement severely limited the number of eligible projects. In the second place, the misconception some people have had that 936 funds are government-owned funds, grants or soft loan funds, when in reality they are purely private, albeit cheaper funds. Fortunately this misconception has been resolved as more people come in contact with the program and realize the private nature of the funds.

In the third place, the market requirement of having bankable projects limits the possibility of using 936 funds in the Caribbean. This market limitation is actually reinforced by Federal banking regulatory requirements which adversely classify most CBI loans extended by commercial banks due to their political or foreign risks.

In May 1988, our office presented this issue to the Federal Interagency Country Exposure Review Committee, the ICERC Committee, in the interest of identifying alternative rules for 936 funded CBI loans. Notwithstanding our efforts, the ICERC Committee rejected our request.

Finally, in addition to these market limitations the program has confronted regulatory constraints. Despite our prompt adoption of local regulations specifically addressing the use of 936 funds in the Caribbean, the lack of Federal regulations made necessary the use of a highly cumbersome and costly case-by-case no objection letter process. Fortunately, the hard work of Treasury and IRS officials resulted in the adoption of much needed temporary regulations. In our opinion, these regulations provide much needed guidelines for CBI investments. Nevertheless, their outlook is unnecessarily restrictive.

Ninth, what changes could be made to improve the 936/CBI loan program?

At this stage, we have overcome some of the major obstacles, such as the very limited number of TIEA signatories. However we believe that it is crucial that the temporary regulations be more flexible in order to facilitate and not encumber the flow of funds to the Caribbean. To that end, we have already submitted specific rec-

ommendations to the Department of the Treasury and the Internal Revenue Service.

And finally question No. 10, to what extent could loan guarantees facilitate the flow of section 936 funds to eligible CBI countries?

We understand that loan guarantees could solve the market limitations inherent to some projects and would, therefore, facilitate the flow of 936 funds. This possibility is of special importance to local Caribbean projects for which credit enhancement is sine qua non for the obtaining of financing.

Having addressed these 10 basic questions, I will be pleased to answer any questions the members may have.

[The statement of Mr. Sosa follows:]

**Testimony of Mr. José A. Sosa,
Commissioner of Financial Institutions
Of the Commonwealth of Puerto Rico,
before the Subcommittee on Oversight
of the Committee on Ways and Means of the
United States House of Representatives**

April 3, 1990

First of all, I must thank you Mr. Chairman and members of the Committee for this opportunity to discuss with you the use of 936 funds in the Caribbean. Since Mr. Colorado has already expounded on the major issues of the 936/CBI program, I believe it is more proper to limit my testimony to answer the ten specific questions posed to our Office in Mr. Chairman's invitation. This of course does not limit my disposition to answer any other questions that you may have.

The specific questions were the following:

(1) What is the total amount of Section 936 funds currently invested in Puerto Rico?

(2) How much of this sum is held by Financial Institutions? How much is directly invested?

936 Funds are invested in Puerto Rico in two forms:

a) Direct investment in eligible or "2j" assets (so called after section 2j of the Puerto Rico Tax Incentives Acts); and

b) Indirect investment in Eligible Activities by way of investing in Eligible Financial Institution which are in turn required to invest said funds in Eligible Activities.

Our Office has been entrusted by law with supervising the use of 936 or Eligible Funds by Eligible Institutions. Therefore, our Office receives monthly reports from these Institutions, with detailed information regarding their Eligible investments. As of February 1990 there were $9,393,697,000 of Eligible Funds invested in Eligible Institutions. (Exhibit A sets out a comparative analysis of total Funds received by the different types of Eligible Institutions since January 1989).

The monthly reports submitted to us by the Eligible Institutions do not cover direct investments, which are individually reported by the companies themselves and not by the Financial Institutions. Nevertheless our estimates indicate that aproximately $4 to $5 billion are invested directly in "2j" assets.

(3) What Institutions or types of Institutions hold Section 936 Funds?

Only Institutions licensed as Eligible Institutions may receive 936 Funds. Eligible Institutions are depository or similar financial institutions expressly authorized to receive 936 Funds and subject to the regulatory requirements of Regulation 3582.

Presently, thirty six Institutions are licensed under the Regulation. A specific list is attached as Exhibit B.

As you can see, all Eligible Institutions have separate underlying financial licenses or charters, for which reason only financial institutions in good standing may participate in the 936 market.

(4) What is the amount of Section 936 Funds held by the Government Development Bank?

As of February 1990 the Government Development Bank for Puerto Rico (the "GDB") had $284,462,000 of Eligible Funds deposited by Eligible Institutions in compliance with the Regulatory requirements (Regulation 3582's Section 6.1.1; 15% Investment Requirement). Under the Regulation, 15% of the Funds received by Eligible Institutions must be invested in loans to the Puerto Rico Government, other Government Obligations, certain interim construction loans by S&Ls or deposited with the GDB. Presently said requirement amounts to $1,027,311,000 of which only $284,462,000 or 27.69% are deposited with the GDB.

(5) What efforts has the GDB made to make loans of section 936 Funds?

The GDB has historically and actively financed public and private economic activities in the Island. Currently, the GDB has extended Eligible loans to both the public and private sectors in the amount of $1,336,997,900. As you may see, the GDB's Portfolio of Eligible loans far exceeds the amount of Eligible Funds received by it. (The actual ratio is $5.26 lent for every dollar received). Therefore, contrary to the belief of some, not one cent of Eligible Funds sits idly in the GDB. In addition, since the bank has traditionally financed Eligible Activities, Eligible Projects are constantly being submitted to its consideration, for which reason no affirmative effort to lend 936 Funds is necessary on part of the bank.

(6) What restrictions are there on the use by the GDB of section 936 Funds for loans to Eligible CBI countries?

In addition to restrictions imposed on it by virtue of its legislative charter, the GDB's CBI lending activity is subject to the requirements of Regulation 3582 and its CBI counterpart, Regulation 3703. In this sense the GDB is subject to the same rules applicable to private Eligible Institutions. Due to its limited charter the GDB's lending power in the Caribbean is limited to financing projects of a complementary nature.

(7) How will your Office oversee loans of Section 936 Funds in Eligible CBI countries to assure that they are in compliance with statutory and regulatory requirements?

Our Office currently overviews compliance with the statutory and regulatory requirements applicable to the 936 market. This supervisory role, which comprises the broad spectrum of administrative actions and authority, has been highly effective in assuring the due use of the Funds in Puerto Rico.

This same supervisory structure is equally applicable to CBI loans, with the added safeguard that all CBI projects must be approved by the Commissioner prior to disbursement of funds. Also, since CBI projects are easily identifiable within an Institution's Portfolio, compliance examinations are much easier. We understand that the present supervisory framework effectively assures statutory and regulatory compliance in the 936 market in general, including CBI loans.

(8) What problems have you observed in the operation of the 936 CBI Loan Program?

In our effort to facilitate the flow of 936 Funds into the Caribbean we have identified the following problems:

1. At the outset of the program the very limited number of countries that had signed a Tax Information Exchange Agreement severely limited the number of Eligible projects. This problem was exacerbated by the fact the the signatory countries at that time had very limited viable projects. It has not been until very recently that the major countries with the highest potential for use of 936 Funds have finally signed, which explains the recent surge in Eligible projects.

2. Some people have been under the wrong impression that 936 Funds are government owned funds, grants or "soft loan" funds. This misconception has been substantially surpassed, as those who come in contact with the program realize that 936 funds are purely private albeit cheaper funds.

3. Due to the private nature of these Funds, only "bankable" projects can really access 936 financing. This limitation is actually reinforced by federal banking regulatory requirements, which adversely classify most CBI loans extended by commercial banks due to their "political or foreign risks". In May 1988 our Office presented this issue to the Interagency Country Exposure Review Committee (the "ICERC Committee"), in the interest of identifying alternative rules for 936 funded CBI loans. Notwithstanding our efforts, the ICERC Committee rejected our request and pointed out the traditional route of obtaining "out of country" guarantees as a way of avoiding adverse classifications. (See Exhibit D) Curiously enough, at the same time the U.S. Treasury Department had initially adopted a very restrictive posture that would have precluded the use of federal guarantees in CBI projects, therefore seriously curtailing the availability of much needed credit enhancement for said projects.

4. In addition to these "market" limitations we have confronted "regulatory" constraints. Despite our prompt adoption of local regulations specifically addressing the use of 936 Funds in the Caribbean, the lack of federal regulations made necessary the use of a highly cumbersome and costly case by case no-objection letter process. Fortunately, the hard work of Treasury and I.R.S. officials resulted in the adoption of Temporary Regulations. In our opinion these Regulations provide much necessary guidelines for CBI investments. Nevertheless their outlook is unnecessarily restrictive as they attempt to directly control the rates and financial structures used in CBI financings. A copy of our comments to the Treasury Department and the I.R.S. is enclosed as Exhibit D.

(9) What changes could be made to improve the 936/CBI loan program?

At this stage we have overcome some of the major obstacles (such as the limited number of TIEA signatories). However, we believe that it is crucial that the Temporary Regulations be more flexible in order to facilitate and not encumber the flow of Funds to the Caribbean. To that end we have already submmitted specific recommendations to the Department of the Treasury and the Internal Revenue Service, which we feel will assure compliance with the congressional intent of Section 936(d)(4).

(10) To what extent could loan guarantees facilitate the flow of Section 936 Funds to Eligible CBI countries?

We understand that loan guarantees could solve the "market" limitations inherent to some projects and would therefore facilitate the flow of 936 Funds. This possibility is of special importance to local Caribbean projects for which credit enhancement is "sine qua non" for the obtention of financing.

Having addressed these ten basic questions I remain at your disposition to answer any questions you may have.

Thank You

EXHIBIT A

COMMONWEALTH OF PUERTO RICO
OFFICE OF THE COMMISSIONER OF FINANCIAL INSTITUTIONS
DIRECT 936 FUNDS
(000)

DATE	COMMERCIAL BANKS	CHANGE in %	SAVINGS BANKS	CHANGE in %	BROKERS	CHANGE in %	TOTAL	CHANGE in %
JAN 89	5,643,264	-	674,993	-	2,559,072	-	8,877,329	-
SHARE	63.57%		7.60%		28.83%			
FEB 89	5,868,223	3.99%	748,368	10.87%	2707688	5.81%	9,324,279	5.03%
SHARE	62.93%		8.03%		29.04%			
MAR 89	5,885,818	0.30%	742,434	-0.79%	2,787,498	2.95%	9,415,750	0.98%
SHARE	62.51%		7.89%		29.60%			
APR 89	5,863,579	-0.38%	757,700	2.06%	2,731,778	-2.00%	9,353,057	-0.67%
SHARE	62.69%		8.10%		29.21%			
MAY 89	5,954,286	1.55%	783,443	3.40%	2,756,244	0.90%	9,493,973	1.51%
SHARE	62.72%		8.25%		29.03%			
JUN 89	6,206,629	4.24%	797,491	1.79%	2,768,494	0.44%	9,772,614	2.93%
SHARE	63.51%		8.16%		28.33%			
JUL 89	6,322,223	1.86%	827,695	3.79%	2,675,484	-3.36%	9,825,402	0.54%
SHARE	64.35%		8.42%		27.23%			
AUG 89	6,231,964	-1.43%	927,414	12.05%	2,759,305	3.13%	9,918,683	0.95%
SHARE	62.83%		9.35%		27.82%			
SEP 89	6,368,148	2.19%	939,652	1.32%	2,738,946	-0.74%	10,046,746	1.29%
SHARE	63.39%		9.35%		27.26%			
OCT 89	6,530,522	2.55%	990,293	5.39%	2,762,531	0.86%	10,283,346	2.35%
SHARE	63.51%		9.63%		26.86%			
NOV 89	6,542,366	0.18%	1,040,039	5.02%	2,776,127	0.49%	10,358,532	0.73%
SHARE	63.16%		10.04%		26.80%			
DEC 89	6,089,711	-6.92%	1,019,575	-1.97%	2,476,079	-10.81%	9,585,365	-7.46%
SHARE	63.53%		10.64%		25.83%			
JAN 90	5,555,487	-8.77%	1,028,178	0.84%	2,082,878	-15.88%	8,666,543	-9.59%
SHARE	64.10%		11.86%		24.03%			
FEB 90	5,939,211	6.91%	1,263,786	22.92%	2,190,700	5.18%	9,393,697	8.39%
SHARE	63.23%		13.45%		23.32%			
JAN 89 FEB 90	CHANGE	5.24%		87.23%		-14.39%		5.82%

EXHIBIT B

BANK

1. BANCO DE CAGUAS
Juan Cruz
Placido González
746-6400 ó 746-8744
746-7208 ó 720-4300

2. BANCO CENTRAL CORP
Antonio Campos
José E. Lopez
Héctor Méndez
753-2513 ó 753-2542
753-2555 ó 753-2500
754-7480

3. CHASE MANHATTAN BANK NA
Tomás Rosario
Domingo Caro
753-3624 ó 753-3630

4. BANCO COMERCIAL DE MAYAGUEZ
Hugo Díaz Molini
725-8500 ó 724-3717

5. CITIBANK NA
Miguel Medina
Marta Alvarez, Head Trader
Angel Valentin
Roxanne Fichbach
Julie Rivera
766-3843 ó 753-5771
763-2323

6. BANCO COOPERATIVO DE PR
Ricardo Gil
Nelson Rivera
751-5181

7. BANCO FINANCIERO DE PR
Jorge Pérez
Antonio J. Muñoz
Miguel Méndez
725-8208

8. FIRST NATIONAL BANK
OF BOSTON
Mr. Michael Blake
756-8080

9. BANCO NACIONAL N.A.
Guido Umpierre
Alfonso Alsina
766-2585

10. BANCO POPULAR DE PR
Jorge Junquera
David Chaffey
765-9800

11 BANCO DE PONCE
José L. Lopez
Vice. Pres. Inver.
José J. Davila
754-9400 ó 754-9180

12. ROIG COMERCIAL BANK
Eric. E. Rivera
J. Adalberto Roig, Jr.
728-1380 ó 728-3020
852-1010

13. ROYAL BANK OF P.R.
Angel Martín
Ileana González
753-2087

14. ROYAL BANK OF CANADA
Ileana González
Saul Santiago
Angel Martín
758-1210 ó 753-2087

15. BANCO DE SANTANDER PR
José L. Gómez
Aleiturri
Nicolas López
754-8650 Ext. 210
756-6581

16. SCOTIABANK DE PR
Noemí Martínez
Marion Vidal
Michael Tomas, Comp.
758-8989 Ext. 2187
756-6498

17. BANK OF NOVA SCOTIA
Noemí Martínez
Marion Vidal
758-8989 Ext. 2187
756-6498

SAVINGS & LOAN

8. CAGUAS CENTRAL FEDERAL
Yolanda Mercado
782-5115
José Lázaro
783-0889
783-3370

19 CARIBBEAN FEDERAL SAVINGS
José G. Vigoreaux
Ramón L. Rivera
762-5050
762-5150

10. FEDERAL SAVINGS BANK
Carole Acosta
740-4444

21. FIRST FEDERAL SAVINGS BANK
Fernando Ochoa
Jorge Rodriguez
723-1442 ó 721-6264

22. GUAYNABO FEDERAL SAVINGS BANK
Rogelio Del Valle
María García
720-8781

23. ORIENTAL FEDERAL SAVINGS

Graciano Vélez
Felix Vega
Héctor Hernandez
852-0378

24. PONCE FEDERAL BANK FSB
Freddy Maldonado
844-8100 ó 843-7557

25. WESTERN FEDERAL SAVINGS
Fermín Contreras
834-8000

BROKERAGE FIRMS

26. CHASE SECURITIES (P.R.) INC.
Ramón Cantero
Mildred Velez
753-3773

27. DEAN WITTER P.R. INC
José López
758-9890

28. DREXEL BURNHAM LAMBERT P.R. INC.
Juan C. Méndez, Cont.
759-8888

29 FIRST BOSTON (P.R.) INC.
Hector Mayor
Gladys Rodriguez
766-4200
766-4141

30. GENERAL ELECTRIC CREDIT CAPITAL SERVICES OF PR INC.
Ramón Meléndez
723-7820

31 MERRILL LYNCH GOVERNMENT SECURITIES OF PR
Sergio Santana
754-5451
754-5497

32. PAINE WEBBER P.R.
Héctor Sueiro
754-4100

33. PRUDENTIAL BACHE P.R.
José Rodríguez
Cesar Gandiaga
753-8585

34. SHEARSON LEHMAN HUTTON INC.
Ivan Pietri
Edwin Nasario
763-0664
759-8915

TRUST COMPANY

. UNIVERSAL TRUST
Scott Wylie
766-4191

35. CITICORP FINANCIAL SERVICES CORPORATION
G.P.O. Box 4106
San Juan, P.R. 00936

EXHIBIT C

Commonwealth of Puerto Rico
Office of the Commissioner of Financial Institutions
G.P.O. Call Box 70324
San Juan, Puerto Rico 00936

May 23, 1988

Mr. Michael Martenson - Chairman
Interagency Country Exposure
Review Committee
20th and C Street N.W. - Office 3440
Washington D.C. 20551

Dear Mr. Martenson:

As you may know Section 936 of the U.S. Internal Revenue Code provides for certain tax credits based on a corporation's business activities within Puerto Rico. To avail itself of these benefits, a corporation must invest locally the funds derived from its active conduct of a trade or business here in Puerto Rico. At present date there are close to $9 billion of "936 funds" deposited in local financial institutions.

Very recently Section 936 was amended to provide for the investment of 936 funds in qualified Caribbean Basin Countries [Section 936(d)(4)]. (See Exhibit A) This amendment reflects the administration's interest of fostering economic development in the Caribbean and in fact tied in Section 936 with President Reagan's Caribbean Basin Initiative ("CBI"). In accordance with the policies our office incorporated CBI Investments as an Eligible Activity under Regulation 3582, which addresses these eligible uses of 936 funds. (See Exhibit B)

Although there is no express obligation to invest in CBI countries, local bankers are encouraged to do so. Section 6.3.3 of Regulation 3582 allows a twenty-five percent reduction of required additional activities. In addition, eligible funds invested within two years of the adoption of Regulation 3582 in CBI loans are exempt from certain investment requirements. (See Section 6.5.9.) (See Exhibit B) These provisions reveal the present interest of both United States and Puerto Rico goverments in using 936 funds as a means of development in the Caribbean.

Nevertheless, this interest may be impaired due to an unintended technical problem which will require clarification.

In the performance of its functions the Interagency Country Exposure Review Committee has set certain adverse classifications regarding CBI countries, which may restrain local banks' willingness to invest in CBI projects. This is the case of, for instance, Costa Rica, the Dominican Republic, and Jamaica.

It is our understanding that ICERC classifications and the CBI provisions of Section 936 and Regulation 3582 were not adopted in tandem, which explains their apparent contradiction. For that reason we present you this issue for clarification and request your ruling that in light of the Congressional intent loans extended pursuant to Section 936(d)(4), and Regulation 3582 be exempted from the automatic adverse classifications set by your Committee and be instead subject to the usual standards of bank examinations.

Truly yours,

[redacted] A. Sosa
General Counsel

ldc

Enclosures

c: Mr. Joseph Duffy
Mr. Edward Lutz

Sec. 936. Puerto Rico and possession tax credit.

(a) Allowance of credit.

(1) In general. Except as provided in paragraph (3), if a domestic corporation elects the application of this section and if the conditions of both subparagraph (A) and subparagraph (B) of paragraph (2) are satisfied, there shall be allowed as a credit against the tax imposed by this chapter an amount equal to the portion of the tax which is attributable to the sum of—

(A) the taxable income, from sources without the United States, from —

(i) the active conduct of a trade or business within a possession of the United States, or

(ii) the sale or exchange of substantially all of the assets used by the taxpayer in the active conduct of such trade or business, and

(B) the qualified possession source investment income.

(d) Definitions and special rules.

For purposes of this section—

(1) Possession. The term "possession of the United States" includes the Commonwealth of Puerto Rico, and the Virgin Islands of the United States.

(2) Qualified possession source investment income. The term "qualified possession source investment income" means gross income which—

(A) is from sources within a possession of the United States in which a trade or business is actively conducted, and

(B) the taxpayer establishes to the satisfaction of the Secretary is attributable to the investment in such possession (for use therein) of funds derived from the active conduct of a trade or business in such possession, or from such investment,

less the deductions properly apportioned or allocated thereto.

(4) Investment in qualified Caribbean Basin countries.

(A) In general. For purposes of paragraph (2)(B), an investment in a financial institution shall, subject to such conditions as the Secretary may prescribe by regulations, be treated as for use in Puerto Rico to the extent used by such financial institution (or by the Government Development Bank) for Puerto Rico or the Puerto Rico Economic Development Bank)—

(i) for investment, consistent with the goals and purposes of the Caribbean Basin Economic Recovery Act, in—

(I) active business assets in a qualified Caribbean Basin country, or

(II) development projects in a qualified Caribbean Basin country, and

(ii) in accordance with a specific authorization granted by the Commissioner of Financial Institutions of Puerto Rico pursuant to regulations issued by such Commissioner.

A similar rule shall apply in the case of a direct investment in the Government Development Bank for Puerto Rico or the Puerto Rico Economic Development Bank.

(B) Qualified caribbean basin country. For purposes of this subsection, the term "qualified Caribbean Basin country" means any beneficiary country (within the meaning of section 212(a)(1)(A) of the Caribbean Basin Economic Recovery Act) which meets the requirements of clauses (i) and (ii) of section 274(h)(6)(A) and the Virgin Islands.

Section 6.2. Eligible Activities. The following loans, investments and other uses of funds shall be the only uses of Eligible Funds qualifying as Eligible Activities:

****

(e) Loans Requiring Prior Approval by the Commissioner. The following loans shall not constitute Eligible Activities unless prior written approval is obtained from the Commissioner:

(i) A loan of the type described in Section 2(J)(1)(E) and (G) of the 1987 Act;

(ii) A loan to finance an investment in active business assets or development projects in a qualified Caribbean Basin country, in accordance with Section 936(d)(4) of the United States Internal Revenue Code of 1986, as amended;

Section 6.3. Additional Investments in Eligible Activities.

Section 6.3.1. General.

(a) For each deposit, Repurchase Agreement or other transaction involving the receipt of Eligible Funds by an Eligible Institution in which the interest rate paid by the Eligible Institution on such funds exceeds the Applicable Market Rate Index, the Eligible Institution shall be required to generate additional Eligible Activity, in excess of the Minimum Eligible Activity Level required to be generated pursuant to Section 6.2.2, in accordance with the Additional Eligible Activity Table.

Section 6.3.3. Credit Against Requirement of Additional Investments in Eligible Activities. An Eligible Institution shall be allowed to reduce the additional Eligible Activity required pursuant to Section 6.3.1 by an amount equal to twenty-five percent (25%) of the principal amount of loans of the type described in Sections 6.1.3(g) and 6.2.4(e)(ii) owned by such institution. Such reduction may not exceed the additional Eligible Activity required by Section 6.3.1.

Section 6.5.9. Exemption from Investment Requirements provided in Section 6.1. Eligible Funds received in transactions with fixed maturities of five (5) years or more having a fixed rate of interest, or with a rate of interest fixed as a specific percentage of a specific published index on the date of the transaction, and Eligible Funds invested within the first two (2) years from the effective date of this Regulation in transactions of the type described in Section 6.2.4(e)(ii), shall be exempt from the investment requirements of Sections 6.1, 6.2.2 and 6.3.

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429

Division of Bank Supervision

August 11, 1988

Mr. Jose A. Sosa
General Counsel
Commonwealth of Puerto Rico
Office of the Commissioner of Financial Institutions
G.P.O. Call Box 70324
San Juan, Puerto Rico 00936

Dear Mr. Sosa:

Your letter to Mr. Martinson as Chairman of the Interagency Country Exposure Review Committee (ICERC) has been referred to the FDIC for a response. Your letter states that there is an apparent contradiction between ICERC's transfer risk classifications of certain countries and the provisions of Section 936 of the Internal Revenue Code, and requests that loans extended pursuant to Section 936 (936 loans) be exempted from automatic classification and be subject instead to the usual standards of bank examinations.

Your request implies that the ICERC process is separate from the usual standards of bank examinations. This is not the case, however. While the evaluation of commercial risk is the responsibility of the individual examiner, the assessment of country risk is the responsibility of ICERC. The findings of ICERC are used by all three federal bank regulatory agencies in their reports of examination; and examiners are not able to classify or categorize loans in the country inconsistently with ICERC findings, except in the case where a more severe classification due to commercial risk is appropriate. Loans to borrowers in the country may not be classified or categorized less severely than ICERC's determinations.

In that regard, your request was considered by ICERC at its regularly scheduled meeting in June. The committee decided that your letter contained no provisions which would serve to mitigate the transfer risks inherent in 936 loans and, therefore, saw no reason to exempt the loans from the classifications or categorizations which were otherwise warranted due to transfer risk reasons. A decision also was made that it would be unwise for ICERC to set a precedent by considering loans on a case-by-case basis.

However, the committee did arrive at some possible suggestions which it would like to offer. A guarantee by a third party, outside the country of the direct obligor, would serve to reallocate the ultimate risk. In addition, while ICERC never has evaluated loans on an individual basis, it has exempted certain categories of loans from classification. For example, several countries, which have suspended payment on most of their external debt, have demonstrated a willingness and ability to service their trade financing and working capital loans of the country's banks. In such cases, ICERC has exempted the trade and bank lines from classification. If, in the future, the countries to which 936 loans are extended demonstrate that they will establish priorities in servicing these loans, ICERC will take this into consideration in future reviews of the particular countries. It is also important to note that the fact that the country is classified due to transfer risk, in itself, does not prevent bank management from making loans which, in its opinion, are otherwise consistent with the principles of sound lending.

Sincerely,

Paul G. Fritts
Director

EXHIBIT D

STATEMENT OF JOSE A. SOSA LLORENS
COMMISSIONER OF FINANCIAL INSTITUTIONS
COMMONWEALTH OF PUERTO RICO

PRESENTED AT
THE INTERNAL REVENUE SERVICE
HEARING ON PROPOSED AND TEMPORARY REGULATIONS
INTERPRETING SECTION 936(d)(4) OF
THE INTERNAL REVENUE CODE

March 19, 1990

The Office of the Commissioner of Financial Institutions of the Commonwealth of Puerto Rico was created in 1985 to supervise Puerto Rico's financial sector. One of its primary responsibilities is to supervise the use of Eligible Funds (or 936 funds) by financial institutions specially licensed for that purpose ("Eligible Institutions"). As such our Office has been entrusted with continuing Puerto Rico's close supervision of the 936 market.

As the direct supervisor of this unique monetary market, the government of Puerto Rico has long been cognizant of the public policy objectives underlying the passive income provisions of Section 936, hence our mutual interest and concern regarding the proper use of Eligible Funds. Basically these objectives may be summarized as follows:

1. Ensuring a lower cost of financing for economic activities which further income, production and employment in Puerto Rico, and
2. Channeling funds to high priority areas traditionally neglected by the financial markets.

For a decade and a half Puerto Rico has successfully regulated the 936 market to achieve these goals, accumulating a wealth of regulatory experience which is now contained in Regulation 3582.

Based on this accumulated experience this Regulation accomplishes its mission by means of the following regulatory provisions:

First, the use of Eligible Funds is limited to investments in a restricted list of EligibleActivities. In this way the benefits of 936 Funds exclusively accrue to those economic activities which further economic development, while at the same time a lower level of demand ensures lower interest rates.

Second, by adopting special Investment Requirements Eligible Institutions are forced to channel a portion of the funds to high priority activities, such as public financing, low income housing, agriculture, tourism hotels and CBI projects; and

Third, special regulatory mechanisms such as the "Tablita" and the Index enhance the "rate reducing" effect of the Regulation by requiring the generation of additional Eligible Activity by the financial institutions.

This oversimplified view of Regulation 3582 summarizes the philosophy of Puerto Rico's approach to 936 Funds, which in essence is to use market forces to achieve the government's public policy of lowering interest costs for economic development projects. By working with market forces instead of against them the Regulation has created a "borrowers' market" in which lenders compete for eligible projects. Under this Regulatory scheme, competition instead of artificial rules reduce interest rates. In addition, the possibility of using diverse financial vehicles is preserved as long as the Funds are used in strictly Eligible Activities

How do CBI loans fit within this regulatory framework? In the area of CBI loans Puerto Rico has essentially followed the same regulatory philosophy with some minor adjustments. These adjustments are found in Regulation 3703 and include more specific definitions of eligible uses which are better attuned to the economic realities of the CBI countries. Also, special due diligence requirements are added to those applicable under 3582.

However important these specific provisions may be, the most significant element of Puerto Rico's treatment of CBI loans resides in our government's very clear public policy

of fostering and facilitating the use of 936 Funds for the economic development of our Caribbean neighbors. Proof of this commitment is our willingness to forego direct benefits to the government and to Puerto Rico's economy in general; benefits that are generated by Investment and other Regulatory requirements, which under 3582 are made inapplicable to CBI loans. In fact no other Eligible Activity in Puerto Rico is granted such preferential treatment. In addition to these regulatory benefits, CBI loans are favored by an expedited review and approval process which grants priority to Caribbean projects.

Let it be clear that these graces in no way imply a lax regulatory scheme. Our Office carefully audits Eligible Institutions to ensure full compliance with the Regulation and stiff fines have been imposed on those few events of noncompliance. In addition, Regulations 3582 and 3703 require case by case review and approval of CBI projects, therefore providing for a closer supervision of the use of funds outside Puerto Rico.

With this brief description of our regulatory philosophy in mind, I would like to make some comments regarding the Temporary Regulations adopted by your agency. Last year the Government of Puerto Rico submitted detailed comments and specific recommendations as to the Temporary Regulations, for which reason I deem it unnecessary to dwell on them in this occasion. Instead, I wish to take this opportunity to address policy issues and not just discuss purely technical matters.

First of all, and as was stated before, Puerto Rico has adopted a very clear public policy of encouraging and facilitating the use of 936 Funds in the Caribbean. Said policy is clearly reflected in the unique benefits solely granted to CBI loans by our Regulation and in the flexibility allowed thereunder for the effective structuring of CBI financings. We believe that many of the restrictions contained in the Temporary Regulations are not attuned to the public policy towards the CBI which we understand is clearly imbeded in Section 936(d)(4).

Secondly, Puerto Rico's regulatory approach recognizes the realities of the market and in fact even makes use of its forces. That is why in Puerto Rico lower rates are achieved, not by imposing interest rate controls, but instead by manipulating the demand for Eligible Funds as described before. In our opinion the Temporary Regulations do not recognize the

realities of the financial markets and instead attempt to directly control interest rates and the actual cost of financing.

Examples of these attempts may be found in Subsection 1.936-10T(4)(iii)(A) which limits reasonable financing costs to two percent (2%) and Subsection 1.936-10T(8)(iv)(C) and (D) which limit the interest rate charged by qualified financial institutions and financial intermediaries in cases in which such intermediation is used. Subsection (D) even requires our Office to determine the "reasonable compensation" to the intermediary.

Eventhough we empathize with your concern regarding unnecessary layers of intermediaries we feel these restrictions are unnecessary in light of the competition amongst Eligible Institutions for CBI projects; competition which has been spurred by the regulatory benefits that Puerto Rico has bestowed on CBI loans.

In our opinion these restraints could easily have the adverse effect of having otherwise qualified recipients precluded from accessing 936 Funds, only because competing Eligible Institutions are unable to profitably finance a given project under market conditions within said regulatory constraints.

Another potential source of such "credit preclusion" is the inherent cost of complying with the Temporary Regulations. In order to ensure full compliance with its intricate rules (many of which have been directly incorporated from the Tax Code), the financial structure of each project has to be carefully scrutinized in such detail by highly specialized tax attorneys that only major projects are worthy of this expensive compliance analysis. I dare even say that many of the Temporary Regulations' intricacies constitute traps for the unwary, this being the result of adopting the Tax Code as a financial regulatory model. Most local and small qualified recipients do not have the necessary technical and/or economic resources, and will in fact get excluded from accessing 936 Funds as a result of the Temporary Regulations.

Finally, these Regulations are far too rigid in defining eligible uses. A clear example of this is the very limited allowance for working capital loans. Section 1.936-10T(c)(4)(iii)(C) (Incidental Expenditures) limits the amount of the borrower's working

capital needs which may be financed with 936 funds to ten percent (10%) of the investment in active business assets and other incidental costs. Such a rule does not recognize the reality that working capital needs are independent of specific capital investments. Actually the former are recurrent and much more frequent than the latter. Such a limitative rule has already precluded the structuring of much needed 936 funded export financing to Caribbean exporters. We believe that export financing is certainly one of the most meritorious and effective uses of Eligible Funds as a tool of economic development for Caribbean countries, for which reason we recommend it be included as a qualified use of Eligible Funds.

I should make clear that our recommendations for a more flexible definition of qualified business assets for the CBI does not run counter to our regulatory objectives of limiting the demand for 936 Funds. This is so because the minimal increase in demand that could result from such recommendations would be substantially outweighed by the significant economic benefits of the increased flow of 936 Funds to the Caribbean.

As I said before, these comments stem from our desire to call your attention to the urgent need for coordinating our efforts and making sure that our joint regulatory framework operates effectively in furtherance of the clear Congressional intent and mandate of Section 936(d)(4), which is to channel Eligible Funds into the Caribbean economies and to emulate the economic development that these same funds have spurred in Puerto Rico. In our opinion this mandate requires the adoption of simpler but effective rules that aid and not encumber the flow of funds. It is precisely this regulatory outlook what we feel is missing in the Temporary Regulations and what we highly recommend be incorporated in them.

Thank you.

Chairman PICKLE. Thank you, Mr. Sosa and Mr. Colorado for your testimony.

Mr. Colorado, just by way of opinions, let me express myself about some of your statements and then we are going to go into questions.

In the summary that you submitted to us about the 936/CBI program, you said that Puerto Rico had promoted a total of 80 projects in the CBI area.

My staff tells me that 68 of those projects do not involve 936 funds. So that when you say 80, 68 of them are not involved in section 936 funds.

And you said they were carried out in 12 CBI countries and there were only six of them that had a tax treaty. The others were carried out separate and apart by direct investment.

You said the project created nearly 14,000 jobs, and we are advised that it created about 100 jobs, not 14,000.

And that over $386 million investment in these CBI countries, actually we only show a total of $102 million actually disbursed.

Now, our statement——

Mr. COLORADO. Can I answer?

Chairman PICKLE [continuing]. Just in contrast to what you have said, I want the record to show that we make that response to you so that you may comment as we go along, or refute them or give your own analysis of it.

Mr. COLORADO. Can I comment right now?

Chairman PICKLE. OK, all right.

Mr. COLORADO. Let me say first, that when you mention the $100 million or when you mention the twin-plant program at the time those issues were discussed nobody mentioned—I mean it was not based on the use of 936 funds. So that the commitment of using the best efforts to help the Caribbean, the twin-plant program and investment in the Caribbean was not limited to the use of 936 funds.

If it had been, it would have been very little that we could have done. For example, you take Grenada, it was not until recently, about 2 years ago, that Grenada signed. But before they signed, we were working projects and we established four plants there which are very, very important for Grenada.

So a lot of the jobs that our program has created are not necessarily in countries that have signed tax information exchange agreements and a lot of the investment is not 936 funds.

Now, the 936 funds have increased tremendously as the countries have signed the tax information exchange agreements. So that is the difference in the numbers is that our program consists of creating jobs in the Caribbean and adding investment to the Caribbean with the help of the 936 companies and with the use of the funds, but not only with that.

Chairman PICKLE. Now, Mr. Colorado, we are going to ask you some questions and I wanted to lay out first to you when you said you had 80 projects that had been approved, I just wanted to point out that there were 68 of them that did not use 936 funds, no matter how you interpret it, that is the fact.

But let us go into some of these questions for you and Mr. Sosa.

Can you tell me, in your own words now, exactly what is your annual commitment to the United States regarding the use of the 936 funds?

What is your commitment to the United States?

Mr. COLORADO. Our commitment is to do as much as we can to help the Caribbean development and the figure of $100 million has been mentioned many times.

Chairman PICKLE. Is your commitment to actually loan $100 million annually?

Mr. COLORADO. No. Our commitment was to do our good faith effort to get as close to $100 million as we could. I can read from——

Chairman PICKLE. Now, are you saying then that you did not make any commitment for $100 million?

Mr. COLORADO. Let me just——

Chairman PICKLE. Just good faith, that is all you are talking about?

Mr. COLORADO. If you permit me——

Chairman PICKLE. Mr. Colorado, that is not what this committee and the Congress felt that you were making a commitment to.

Mr. COLORADO. Well, let me read what Congress thought in a letter by David Broadway to Mr. Rangel. Which says, it is not my view that this language is intended to hold the government of Puerto Rico to a higher standard than the good faith effort referred to in the statement of managers. That is a good faith effort, that is interpretation and I think that has been very clear. There is no one, single moment in which Puerto Rico said that it would get to the $100——

Chairman PICKLE. And you are saying——

Mr. COLORADO [continuing]. But we have done it.

Chairman PICKLE [continuing]. That you do not need to meet the $100 million level? If you can, fine, and if you cannot, that is OK too. You are not obligated to do it.

Now, I am saying that is contrary to what our intention is as I asked the Secretary earlier, were you or Puerto Rico going to vigorously pursue, and have you vigorously pursued loans up to $100 million per year?

Mr. COLORADO. Yes, we have, yes, we have, very vigorously.

Chairman PICKLE. Now, the two islands down there, Barbados and Jamaica——

Mr. SCHULZE. Would the gentleman yield on that point, before he goes on, just on that commitment.

Mr. Secretary, I realize if you follow the legislative history of the memorandum of agreement between the Government of the United States and the government of Puerto Rico that it was very succinct. Then it was changed a little bit and then in the language of the report, which accompanied it, I believe then those words that you use were in that report.

But if you read the memorandum of agreement, it says pretty clearly, "Puerto Rico will guarantee $100 million of new, private, direct investment annually in CBI countries."

Mr. COLORADO. And the letter from Mr. Brockway says——

Mr. SCHULZE. Now, I realize that it is modified somewhat by that and if you really want to say, well, it is not really a commitment, I

realize there is a place in there where you can read that. But I think that there was an emotional commitment.

You remember very well all of the negotiations that were going on and maybe we just have a differing opinion.

Mr. RANGEL. Would the gentleman yield on that point?

Because I need some clarification too.

You bet your life there was a lot of emotion. And it looked as though 936 was going out of business until this concept of twin-plant came up and the commitment was made. Now, I do recall language being used that sounded like guarantee. And it was for that purpose that I then wanted a clarification to see whether or not we were going to keep Puerto Rico's foot to the fire, because I agree with you, there was this guarantee type language.

And now, since that time, and as a result of this, Joint Committee wrote back and indicated that it was not a guarantee and that Puerto Rico was supposed to make a good faith offer.

Now, let me make it clear, I will not want Puerto Rico to do anything less than what the interpretation of that statute is, and so let us make it clear that if Treasury said they did not mean guarantee, then I do not think this committee means guarantee.

Mr. SCHULZE. Charlie—just briefly, Mr. Chairman—I have to agree with you that if we are going by the letter of the law, that during those discussions we wanted to create economic activity in the Caribbean, that was our goal. That was why we said you have section 936 and it is a good deal and use some of that money. That was the thrust, that was the intention, that was the direction in which we should have gone.

Mr. RANGEL. I want to be just as critical——

Chairman PICKLE. Mr. Rangel, let me interrupt you. I want to reclaim my time. I had yielded to Mr. Schulze, and Mr. Schulze had yielded to me and I have not gotten started here.

I will recognize you in just a minute, unless you insist in proceeding.

Mr. RANGEL. No, go ahead.

Chairman PICKLE. All right.

Now, I will ask Mr. Colorado at this point. The $100 million was a figure that we had talked about that we had come to that later. And now the disagreement is, are you really bound to that figure?

So let me ask you now,. would you object, either you or Mr. Rangel, if we codify that, if we put that in the statute?

Mr. COLORADO. From the figures that we have, Mr. Chairman, from what we see happening now, after countries are starting to sign the tax information exchange agreement, we see that by the end of this year, we will probably have more than $500 million invested. And we are in no way holding back projects from being developed.

So I believe that the matter of the $100 million is not going to be an issue probably 6 months from now. As a matter of fact, already we have in approved projects which have been approved by the banks, over $300 million of 936 funds, which is the amount required for the last 3 years, if that were so.

But I have to state for the record, again, Mr. Chairman, that the letter from Mr. Broadway says, the memorandum of agreement

never progressed beyond draft form, was never agreed to and has no binding force.

Chairman PICKLE. Mr. Colorado, we are all in general agreement that it was not finalized and put into statute. I am simply asking you now, why not put it into statute? Why not codify it? If it is $100 million, $200 million or $300 million, would you be agreeable if the Congress does that?

Mr. COLORADO. With the circumstances that we have now, we foresee that a $100 million a year will be obtainable, has been obtained already. And we will continue to go.

Chairman PICKLE. In order to get more disbursements of funds, suppose we made it $300 million?

Mr. COLORADO. It is not going to make any difference, because it is not what you put in the law, what is going to be available is what we can do and what the countries can do.

Chairman PICKLE. Then you do not object if we codify it?

Mr. COLORADO. If you qualify it in a way that we can do it, that is something else.

Chairman PICKLE. Now, the Ways and Means Committee report referred to grants by Puerto Rico. Did Puerto Rico intend to make grants of these 936 funds?

Mr. COLORADO. I do not recall that we mentioned after the law was changed, grants, but we have invested a lot of money in the Caribbean development program. We are talking about millions of dollars which we have invested in producing——

Chairman PICKLE. Well, Mr. Colorado.

Mr. COLORADO. Yes?

Chairman PICKLE. You must not have intended to make any grants because you have made no grants at all in 3 year's time.

So you did not intend to make grants, is that not understood?

Mr. COLORADO. Grants as such, to any company, I do not believe we have, no.

Chairman PICKLE. Well, if we did not have any grants, so really all the 936/CBI program allows is for a borrower to get lower interest rates on funds held by commercial banks and you say that is correct, is it not?

Mr. COLORADO. That is correct and that is exactly what we have in Puerto Rico.

Chairman PICKLE. Now, these funds do not belong to the government, do they? They belong to the individuals?

Mr. COLORADO. Right.

Chairman PICKLE. You just stated that.

So I ask you then, how could Puerto Rico make a commitment on these funds when you do not own them in the first place?

Mr. COLORADO. We made a commitment to try to get to a $100 million investment, to do our best efforts to convince the companies to get the projects and we have done that. That was our commitment.

Chairman PICKLE. You may have tried to. I am not disagreeing with that, but the fact of the matter——

Mr. COLORADO. I think we have.

Chairman PICKLE [continuing]. Is it that you did not control these funds, they are controlled by the banks. You could not have

made a commitment in the first place, and you knew that when that agreement was made in 1985–86, did you not?

Mr. COLORADO. Mr. Chairman, we did not make that commitment.

Chairman PICKLE. All right, now, if Puerto Rico does not meet its commitment of $100 million—and that is what we had talked about in this committee and throughout the Congress, and if these loans are not closed in any 1 year, then my question would be, what would Puerto Rico do and what should the Congress do?

Is the commitment enforceable?

Mr. COLORADO. The intention of our discussions with Treasury and the way that the law was presented and the compromise was that we would be able to utilize the funds in the Caribbean Islands if they signed the tax information exchange agreement. The $100 million that were mentioned way before that, did not take into account that we were going to be limited to two countries at that time. So there was no way that anybody could finance the same amount of money in two countries at that time.

Chairman PICKLE. Well, under the law, at this point, I think it is understood that we cannot enforce that particular sum at this point, either by our government or anybody else, is that not correct?

Mr. COLORADO. Enforce what?

Chairman PICKLE. Well, if you only disburse $20 million——

Mr. COLORADO. We do not disperse and we do not spend.

Chairman PICKLE [continuing]. We cannot make you do the other $80 million under the present law.

Mr. COLORADO. Mr. Chairman, we do not disperse and we do not spend. The points are used by the banks, through the banks into the different countries in loans that are approved by them. It is not Puerto Rico that dispersed moneys.

Chairman PICKLE. Well, now, in your list of complementary operations in the CBI, you show 67 projects for which no 936 funds were used. That is in your statement.

Do you think that Puerto Rico should get credit towards its commitment for investment made by 936 companies, even though no 936 funds were involved?

Mr. COLORADO. Absolutely, yes.

Chairman PICKLE. Now, you tell me why?

Mr. COLORADO. I will tell you why. Because the original commitment did not—let me explain something. When we were talking about the $100 million, it could not have been of 936 funds because 936 funds could not have been in use in those countries by law. So you must have that clear.

The 936 funds were not an issue to be utilized in the countries, that came as the legislation was approved.

So the projects that we were talking, the investments that we were talking about was the combination of efforts by Puerto Rico and by the 936 companies to establish manufacturing operations and economic development projects in those countries so that was the main basis for our help.

And that is what we started doing immediately, even before the law was approved.

Mr. RANGEL. If the Chairman would yield for clarification on this point.

I have taken the liberty, Mr. Chairman, to check with staff and they supported what I already thought. That any talk about the $100 million was a commitment from the government of Puerto Rico but certainly not earmarking it to 936 funds?

Chairman PICKLE. Well, Mr. Colorado, I am just simply asking you that when you say that you have developed 67 projects, in which you said no section 936 funds were actually used, you still want to get credit for having actually dispersed that amount of money.

Mr. COLORADO. Those loans——

Chairman PICKLE. What right do you have to claim it? I want you to tell me. I want to say it once more.

Mr. COLORADO. Because we promoted the—when we sent a letter to Dick Darman at Treasury, when we communicated with him, there was a commitment from Puerto Rico long before the legislation was approved, and from a number of 936 companies to promote and to create jobs in the Caribbean.That was the basis for our program. It was not the use of the funds. So how are we not going to get credit when the effort has been very difficult and where we, together with the companies have been able to create that amount of jobs?

As a matter of fact, the amount of jobs which are there, are more than half of all of the jobs created by manufacturing plants in the Caribbean under CBI. More than half of them have been created through Puerto Rico and by the 936 companies.

Chairman PICKLE. Well, you are saying then that if a company in Puerto Rico makes $10 million in profit and they invest it into another country directly, not through 936, that you should get credit for the program?

Mr. COLORADO. No, no, no.

If under our program of economic development for the Caribbean, we promote, we have done more than 40 seminars in many of these countries. We have done seminars in Europe and seminars in the Far East, seminars all throughout the United States trying to bring industry into the Caribbean. And now, as a result of that, is that we have been able to get these companies to put their production plants in the Caribbean.

This does not take into account other companies that may have been going there related to Puerto Rico. It takes into account the ones that we have worked with and that we have either lent, in some cases, the Government Development Bank in Puerto Rico has lent them money to be able to do that operation in other places. So that is the kind of project we are talking about. Either finance with 936 funds, where it is possible, or through our promotions getting those jobs generated in those countries.

Chairman PICKLE. I thank you, Mr. Colorado.

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

Thank you, Mr. Secretary and Mr. Commissioner for your testimony.

Mr. Secretary, on page 7 of your statement, you talk about FOMENTO's economic impact assessment, it says, that the assessment

assures that projects do not adversely affect the economy of Puerto Rico through the loss of jobs or the idling of plants and equipment, and it would not create an adverse impact upon the economy of Puerto Rico through the outflow of section 936 funds.

That sounds like a formula for not lending. Because you could probably take almost any project and say, it could have that kind of an impact.

I am concerned, and I believe you heard my question to the Secretary, that I am concerned that you are not fulfilling the role that we want you to play. As we discussed in my office, I believe you have a marvelous opportunity to become the economic center of the Caribbean and I think in a way that you have passed up that opportunity, and let other areas utilize it.

This money is only 40 percent of the assets of the financial institutions, so it is not the big bulk of the money in Puerto Rico you have built roadblocks instead of cooperating in the lending.

Now, I would like you to dispel me of that and tell me that FOMENTO really does not do that or just give me your response to that?

Mr. COLORADO. Oh, I could clearly tell you that there is nothing further away from the truth than what you have just stated.

I will tell you why. There has been not one project presented to us that we have rejected, OK? There has been not one project.

Mr. SCHULZE. So FOMENTO does not assess the effect of——

Mr. COLORADO. We assess it, but of all of the projects that have come, there has not been one single project to which our assessment has been to say that it competes with Puerto Rico and therefore, not funded.

Mr. SCHULZE. Is that because of this standard, that people will say that we know better than to present this because it will be in direct competition?

Mr. COLORADO. No. Now, something has to be very clear. The tax exemption for the so-called 936 funds is not only granted by the United States. The primary taxing jurisdiction is Puerto Rico and so the one that grants tax exemption to those funds is Puerto Rico.

See, if 936 is eliminated, for that purpose, a credit would have to be given in the States for the amount of taxes paid to Puerto Rico. Puerto Rico, not being a state, has autonomy on their fiscal legislation. And these funds are not taxable by Puerto Rico. We are foregoing our taxes and therefore——

Mr. SCHULZE. Are tax credits now given for tollgate taxes?

Mr. COLORADO. Yes, sir.

Mr. SCHULZE. What does that amount to?

Tell me about, explain perhaps for the committee, the Puerto Rico's imposition of the tollgate taxes and how it works?

Mr. COLORADO. The imposition of tollgate tax is a maximum of 10 percent for those companies which are exempt in Puerto Rico and normally it can be reduced, because it is both in the interest of the United States and Puerto Rico that we have long-term financing, so that it can be reduced from 10 percent to 5 percent if the moneys, if part of the moneys are left there for a longer period.

It can also be reduced even to zero percent if those funds are left in investments for 10 years in Puerto Rico. Now, the amounts of profits earned on the investment of the original profits, I am talk-

ing about 936 funds, are exempt from tollgate tax in Puerto Rico, and therefore, with the combination of the extension of 936 in the States are totally exempt.

Now, if Puerto Rico would impose taxes on them, then the United States would have to give a credit.

Mr. SCHULZE. How much do you collect from tollgate taxes?

Mr. COLORADO. We are collecting now from $150 to $200 million.

Mr. SCHULZE. $150 to $200 million. Mr. Secretary, where does FOMENTO derive its authority to impose those restrictions on loans that you have stated that would adversely affect the economy of Puerto Rico or have adverse impact on the outflow of 936 funds? Is there a statutory authority for that imposition, and is it something you must follow? Or is it just a matter of FOMENTO rules?

Mr. COLORADO. There is a statutory authority through regulations which established that the loans granted to the Caribbean must be approved by FOMENTO and by the commissioner of banking.

Now, as to the 936 funds, it is not as to the U.S. legislation; it is as to our legislation. It is our taxes, the ones that we are foregoing, and the ones that we are saying we will grant or not grant if it hurts Puerto Rico.

Now, the same way that one of the members of the committee or the subcommittee mentioned a few minutes ago that he was concerned with the purchase of two airplanes which were not made in the United States, in Puerto Rico we are very concerned in foregoing taxes for projects that will hurt Puerto Rico, obviously.

Now, the United States can grant them, but we will not. So that is the issue. There are two taxing jurisdictions. What we are saying is the United States can open the doors, as we can open it for the planes of other countries until the law is changed, on our own legislation and regulation. The United States can say, OK, we need no approval, just the regulation and that is it.

Mr. SCHULZE. All right. So that in FOMENTO's charter, it actually states these——

Mr. COLORADO. Not in FOMENTO's charter. In the legislation relating to the use of 936 funds or to the use of industrial funds in Puerto Rico.

Mr. SOSA. Mr. Schulze, if I may?

Mr. SCHULZE. Certainly, Mr. Commissioner.

Mr. SOSA. The statutory provision is the Puerto Rico Tax Incentives Act. Pursuant to that act, a regulation is promulgated, and that regulation expressly indicates that CBI loan projects have to be approved by FOMENTO, which conducts its economic assessment, and by the office of the commissioner of financial institutions.

So as Mr. Colorado was pointing out, this stems from Puerto Rico's statutory provisions.

Mr. SCHULZE. Do you view this as a possible roadblock or restriction on the reasonable flow of funds to the Caribbean Basin?

Mr. SOSA. No, because, as you may know, the economic nature of these countries is very different from Puerto Rico right now. So most of the projects that have been presented—I would say all of the projects that have been presented to our consideration— do not pose this problem.

In fact, if we compare the nature of this requirement with other Federal requirements, such as the limitation to TIEA signatory countries and to the Federal banking regulatory adverse classification of CBI loans, this is a minimal requirement.

Mr. COLORADO. We approve our loans normally in 1 or 2 weeks, or 3 weeks at the most, without any problem going through the two agencies, and we have not denied one yet.

Mr. SCHULZE. I hear you, and I hope you are right. All I can say is the language gives me pause, gives me some concern, because it could be utilized to restrict loans.

What has FOMENTO done to encourage investments by 936 companies or other banking institutions which have large 936 deposits to make these loans non-936 funds loans in the Caribbean Basin?

Mr. COLORADO. Well, I have a list which I will leave with you of all of the activities that FOMENTO has done.

Mr. SCHULZE. Do you have a figure on that, by any chance, of how much the total of those non-936 funds loans were made in the Caribbean Basin?

Mr. COLORADO. Oh, non-936 loans?

Mr. SCHULZE. That would be very helpful.

Mr. COLORADO. It is in my presentation to you.

Mr. SCHULZE. Is it substantial?

Mr. COLORADO. The amount of the investment is about $80 million.

Mr. SCHULZE. See, quite frankly, if it is——

Mr. COLORADO. In addition to the other 300.

Mr. SCHULZE. If it is substantial, that would say to me then it is working.

Mr. COLORADO. It is about $80 million.

Mr. SCHULZE. Because the 936 funds are freeing up this other money, and it is being loaned around in the Caribbean Basin.

Mr. COLORADO. Yes.

Mr. SCHULZE. If you would get that for us.

Mr. COLORADO. No, but these are not necessarily funds which are in Puerto Rico. These are investments by the companies which are in Puerto Rico or by companies related to Puerto Rico, and normally what we call the twin plants. You were very right a few minutes ago to mention—I think it was the chairman—that the twin plants is one thing, and the use of the funds are two different things. Today, though they, you know, complement each other, they are two different things. And many of these projects are complementary plants or twin plants, and some of the projects are just what we call stand-alones, where loans have been granted for them to create the infrastructure in many cases.

Mr. SCHULZE. In conclusion, let me just say I wish that the system had loaned out $400 or $500 or $600 million in small- and medium-sized loans all throughout the Caribbean. We all know that there are smaller islands where $20 or $30 or $50 or a $100,000 loan can make a huge difference.

I am somewhat disappointed that this has not happened. This was the whole thrust of what we wanted you to do. So just in case there is no misunderstanding, if we come back in 3 years and you say we didn't—what we really want you to do is help the whole

region. We are willing to say keep these funds if you are willing to do that.

Now, see, where I believe you made a mistake. You could have developed a broad base of support for this program that we could never change it, never have even considered changing it. I believe you sort of missed the boat on that.

So you understand, we really want you to take this money and put it out and help the whole area. If you have to change your rules and regulations to do it, please do that so that we don't come back here in another 3 years and go through this.

Thank you.

Mr. COLORADO. Congressman, I would like to add that we are completely in agreement, except missing the boat. This is a slow boat. It takes time. It is going much faster now. I agree with you a hundred percent in everything you said, except that once you get in the boat you realize it is not as easy as when you are outside of the boat.

Mr. SCHULZE. I want you to get out of the tug and get into a——

Mr. COLORADO. Don't worry. I have been doing that, and you will get the information.

Mr. SOSA. Mr. Congressman, if I may add, the slow movement of that boat does not stem from our regulatory provisions. No project has been denied due to noncompliance with local regulations. Problems have stemmed from the approach adopted by the Treasury Department during the first case-by-case review process and now under the temporary regulations. And we certainly agree that a flexible regulatory framework geared towards the economic development of the area is what we need, and that is what precisely what we have suggested to the U.S. Treasury and the Internal Revenue Service.

Chairman PICKLE. Thank you, Mr. Sosa.

Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman.

Just a point about Mr. Sosa's response to Mr. Schulze, I think you ought to go back and reread Treasury's testimony, because they do lay some fault at your feet for the multiplicity of jurisdictions and multiplicity of agencies——

Mr. SOSA. I am glad that you point that out.

Mr. ANTHONY [continuing]. That your loan requirements and your approval process go through. So either you are right and Treasury is wrong, or maybe we need to get a better clarification of this.

Mr. SOSA. Well, if I may clarify this issue, I understand that Treasury's comment relates to our suggestion regarding the use of multiple financial intermediaries in the Caribbean. I understand that said comment has nothing to do with the approval process. I am positive that the combined action of our two administrative agencies—FOMENTO and the commissioner's office—is much faster than Treasury's action alone.

Regarding that point about the use of multiple intermediaries——

Mr. ANTHONY. Let me ask you this: Do you agree with Treasury's temporary regulation that you should be just limited to one financial intermediary?

Mr. SOSA. No.

Mr. ANTHONY. Why not? Does that not simplify things?

Mr. SOSA. No, no. Because this does not deal with the approval process itself, but it is tampering with——

Mr. ANTHONY. Yield a minute to me, would you, please?

Mr. SOSA. Yes, sir.

Mr. ANTHONY. You said it doesn't apply to the approval process, yet if you have to go through multiple financial intermediaries, it is a stumbling block whether or not it is part of the agency's requirements or not. The person who is asking to borrow the money has to comply with that requirement. So it is an impediment the more intermediaries you have.

Mr. SOSA. Well, we must make something clear here. We are not requiring multiple intermediaries. We are just saying that the use more than one intermediary should not be forbidden. And when I am referring to the approval process, I am referring to the regulatory approval process and not to the approval process of the financial institution.

Mr. ANTHONY. No, I understand that clearly, but you are talking about going down one process, but I am looking at it from a broader standpoint of the borrower or the applicant. Sure, he can have an easy time with you, but then if he has got to go through a multitude of financial intermediaries, each one of those contacts contains a complicating factor. If you have just got to go to one place, then you should have a much more simplified an easier time of it. If I am mistaken—and if you can do better by having 15 intermediaries than we can with having one intermediary, then you have got a different set of business requirements than I can expect.

Mr. SOSA. I must indicate—and this stands on the Treasury's and the Service's record regarding our suggestions—that we empathize with the idea of having only one intermediary in each transaction, and that our concern in having more than one intermediary has nothing to do with the cumbersome process that might ensue from having more than one financial institution, but from the costs that could be involved. That, I think, from a policy standpoint is a more important thing.

Mr. ANTHONY. So your position is that the more intermediaries you have, the lower the cost?

Mr. SOSA. No, no. If there is——

Mr. ANTHONY. Is that what you just said?

Mr. SOSA. If you will allow me to complete the statement, if you have a concern regarding multiple intermediaries, our position would be that that concern should be the increase of costs that could result from having more than one intermediary. However, we must point out that from the way the 936 market works in Puerto Rico and as we have seen it work in the Caribbean, said market is a very competitive one, and no borrower will go with a transaction with unnecessary layers of intermediaries because the competition clears that out.

And why is there a level of competition amongst financial institutions to do CBI loans? Because in Puerto Rico, our regulatory framework grants a special treatment to CBI loans which is not granted to any other loan in Puerto Rico.

Mr. ANTHONY. I understand, and I am on the same wavelength that you are. We just have a difference of final interpretation.

Mr. COLORADO. Congressman——

Mr. ANTHONY. If you would permit me to fire off a few questions, and then I will give you an hour-and-a-half to explain anything you want to explain. But I would just like to ask some straightforward, simple questions.

Puerto Rico feels that it is under an obligation to make a good faith effort to $100 million in other Caribbean countries outside of Puerto Rico?

Mr. COLORADO. Invested, yes, sir.

Mr. ANTHONY. You understand that there are two separate concepts of $100 million investment and then a twin plant concept investment, that they are two concepts that we are working on?

Mr. COLORADO. I believe that as far as we are concerned, and obviously since we started the program, we are talking about investment in the Caribbean through twin plants, to stand alone projects, through loans, anything that would comply with economic development in the area. That is what we have been trying to do.

Mr. ANTHONY. I understand. So, when you do that, you break it down into two separate investment components. One that has 936 funds, and those stand alone projects that would not have 936 funds but would be direct investments by CBI countries who benefit from 936. So you have got two programs.

Mr. COLORADO. We have one program that——

Mr. ANTHONY. I am talking about under your scorekeeping——

Mr. COLORADO. My scorekeeping tips. Everything together except that we take out for your purposes the use of 936 funds.

Mr. ANTHONY. OK. I understand that.

What I am getting around to is an old slogan that says don't fix the roof because it's not raining. And I think that is what you got into the discussion with Chairman Pickle when he asked you would you mind codifying into 936(d)(4) Puerto Rico's responsibility to invest $100 million on an annual basis.

Your response was it is not needed and necessary because we are doing more than that.

What bothers me about your answers to his questions, if I heard you properly, is that the good faith effort, in your opinion, is complied with if there is $100 million annually made directly by companies that are subject to the 936 tax credit?

Mr. COLORADO. That was exactly what we were committed to. That never happened because the draft was never approved. That was exactly what we were talking about.

Mr. ANTHONY. I understand. But had that been codified, what bothers me is that if the pharmaceutical companies and/or the companies down there, the 625 that are drawing benefits, at least did $100 million, then Puerto Rico is off the hook to do anything under a twin plant concept with 936 funds.

And I just think that is erroneous scorekeeping. That is the reason we are holding these oversight hearings to see if some corrective regulations or corrected legislation is necessary.

Mr. COLORADO. The agreement was not made, it was not made to put Puerto Rico on the hook. It was to put the companies on the

hook. So if the companies paid one way or the other, it had the same effect in the countries in the Caribbean.

Now, the benefits of section 936 are such that we are getting countries to sign the tax information in exchange every minute to use the pot.

Mr. ANTHONY. No. I understand clearly what you are saying. You are saying that Puerto Rico's good faith effort has been met if other companies make an investment not restricted to 936 funds.

And as one member of this committee, I am telling you that you are walking on real thin ice when you start looking for future support for that type of a concept.

Mr. SOSA. Mr. Anthony, could I add one comment?

Mr. ANTHONY. If you will yield, I will be happy to yield back to you. My time is growing short and I wanted to get into two areas that Ken Gideon said he could not answer.

One is the AT&T $17 million cable transaction. And I just have one straightforward question for you.

Was AT&T so strapped for cash that the project would not have gone forward had they not been able to tap into the lower cost of capital through the 936 funds?

Mr. COLORADO. There is no one that can get use of 936 funds that cannot get use of other funds. The purpose of 936 funds is not to give a loan where a loan is not available. The section 936 funds have been used in Puerto Rico for a number of years and are being used in the Caribbean to reduce the cost of the loan, not to make a loan available where a loan cannot be available. And this is probably one of the, you know, biggest misunderstanding that we have. And this is a problem.

Mr. ANTHONY. I don't think we have a misunderstanding. I think we have a misunderstanding in terms of where the money should be directed.

See, had I been serving on that board that made that decision, I would have told AT&T to go to the marketplace. I would have taken the $17 million and I would have looked out in all those multitude of investment seminars that you produced all over the Caribbean, I would have found a small businessman that was not as sophisticated as AT&T, and I would have invited him to make an application for $4 million. This would result in the creation of jobs in some of these other countries. That is what I would have done. That is just the difference in the way I would have allocated the funds and the way you will allocate the funds.

The same way with Air Jamaica. It is my understanding that the way it was first originated with Air Jamaica, it was nothing but a straightforward refinancing.

Mr. COLORADO. No, that is not true.

There were two projects for Air Jamaica. There really never was refinancing, and Treasury said no.

The second one was the purchase of the plane, and Treasury approved it. They were two different. They were completely different.

Mr. ANTHONY. They purchased it only because the Tax Code calls it a purchase. It is a 10-year lease——

Mr. COLORADO. With a purchase.

Mr. ANTHONY. It is a 10-year lease with a residual value purchase at the end.

Mr. COLORADO. Right.

Mr. ANTHONY. So it is a lease arrangement commercially, but the Tax Code calls it a sale. So, therefore, you can testify that it is a sale. But it was set up in a very complicated, convoluted, around the horn manner that took one individual working for ALG over 1 whole year to try to put the situation together.

Again, had I been serving on the board down there, I would have gone to the Jamaican government, and I said let's do something directly rather than doing something indirectly.

Mr. COLORADO. Congressman, that is exactly what I did. That is exactly what I did. As a matter of fact, I went to the Prime Minister himself right after the elections, and I told him can we do something better? Their commitment was such that they could not do something better. And the only thing better they could do was use 936 funds. And you have a representative from Jamaica explaining that transaction to you here. That is a reality.

Mr. ANTHONY. Well, I would love to hear them explain how they saved money by not going direct but by spending over $1 million in costs to an intermediary, a dealmaker, and that they can call that cheaper.

Mr. COLORADO. That is why we used 936 funds. That is the meaning of 936.

Mr. ANTHONY. And if Mr. Rangel is correct, in which I concur, that tourism is probably the quickest dollar that the Caribbean countries can earn, and that you need transportation to get down there and, therefore, that could enhance and create tourism.

I do not disagree with that side of it. But what I am terribly concerned about is this long article that was published in the October 2, 1989, Commercial Aviation report that talks about what a complicated, convoluted financial transaction it was in order to tap into 936 funds. And I guess what I am asking for is kind of what Mr. Chandler asked for, is that the most efficient way that we can operate 936? Can't we devise a more simplified direct approach that would cut out as many dealmakers and let the principals operate and set up the criteria and the requirements.

That is what I am looking for so that, in the final analysis, there will be more real dollars that will go into more job producing plants.

Mr. COLORADO. Congressman, I agree with you.

Mr. ANTHONY. I do not think that you can testify that there were any direct jobs created by you financing lease arrangements on two foreign purchased airplanes from Brazil.

Mr. COLORADO. When I went to talk to the Prime Minister, that agreement had already been made. Therefore, they could not change the agreement. They were either tied up to an agreement that would have cost them much more, or do it with 936 funds and have a reduction in the cost.

So there was no other way.

Now, obviously, it was the first project that was done of its kind. So it took time. And they had to make changes between the first time they came in to the end. It was a very, very unique situation.

Mr. ANTHONY. So you anticipate a lot more deals like this being made now that you know how to do them?

Mr. COLORADO. I imagine that the new deals, whatever they are, are right now under—we had three deals at that time, now we have about 10 or 12. And we have much more in storage.

Now, those deals will be much more simple now.

Mr. ANTHONY. And you got these outside dealmakers in the middle drawing down million dollar fees?

Mr. COLORADO. Those were there already in that deal. The company dealmakers were there.

Mr. ANTHONY. I understand that.

Mr. COLORADO. Jamaica could not get out of that deal.

Mr. ANTHONY. Do you have more deals on the drawing board—do you have more deals like that deal that are presently being considered?

Mr. COLORADO. Like that one, I would say no. And I would say that in many deals that we make, the borrower is going to save money, and that is the reason you use 936 funds.

Now, when we were talking about, your mentioning intermediaries. What we were talking is you want us to put money in the Caribbean in people, in smaller projects. Who knows those people? The banks in the Caribbean; not the people in Puerto Rico.

So the only way to give those loans in the Caribbean is through the banks. There you have one intermediary.

Mr. ANTHONY. Well, let me just close my part by saying this. I did not vote for the twin plant concept, save 936 to give AT&T lower interest rates to build part of their system when they are going to the outside market for the rest of their Caribbean infrastructure development. And I am not so sure that voted to allow the government of Jamaica to be able to lower its costs just a little bit, just because somebody sitting over in some leasing company in Iowa, of wherever they are located, were smart enough to figure out how to do it.

I can tell you what my intent was. My intent was to encourage Puerto Rico and other people to spend money in these other countries that would create some jobs, straightforward new construction and some new jobs.

Maybe my vote was a misguided vote, but I will get another opportunity before this year is out to cast another vote. And I will get a chance to vote it on a more intelligent basis because of these oversight hearings. But, having said that, I am as strong a supporter of the Caribbean as Mr. Rangel is, and I have tried to work with him because I believe in the program.

And I guess maybe what we have got to try to find a way to do is to simplify some of these processes, and maybe we have got to set up a more detailed auditing situation so that we have got a better opportunity to scorecard the project as we go along.

And I think maybe that is part of the confusion that we have here. I do not disagree with anything that you have said. And I understand your analysis of the situation. I just happen to be sitting on the other side of the desk looking at it from a different perspective.

Mr. COLORADO. Congressman, I guessed at some time ago, that the committee or the subcommittee would get someone to work with us on a continued basis to keep this scorecard and to realize what this project means and what this project is.

As a matter of fact, I went even further, and I said we are willing to pay for it, for that person who can communicate all the time with you and give you information and keep the scorecard or whatever. Because, see, when you say that what we should have done is go there, get four small companies, and give the loans. That is what we want to do.

That is what we want to do, and many of these projects are those. Now, we can do it in only two countries that have signed the tax information exchange agreements, so we had to go to other countries and do other types of projects.

Now, I could have waited. As a matter of fact, I remember I mentioned to one of the staff sometime ago, about 3 years ago, I can sit down, wait until tax information agreements are signed, and then invest in only those countries if that is what I am going to be accounted for.

On the contrary, we did not do that, because I thought what the Congress wanted was Puerto Rico to get involved in the Caribbean, create jobs in the Caribbean, get investments in the Caribbean, everywhere, even in countries that had not signed at that time the tax information exchange agreement. The tax information exchange agreement gave them the opportunity then to get lower interest income.

That is what we have been doing. It is not easy, but we are getting there. And I can assure you that the figures are good, that the numbers that have been created are good. And a week ago, I was not planning on meeting with the President. I have met with almost every President and any Prime Minister that have signed the tax information exchange agreement, or at least getting one. And we have been very, very, very persuasive for a simple indication of Trinidad and Tobago. And in the case of Grenada and Dominica.

It was very important participation to get these people to do what you wanted, sign the tax information exchange agreement. Then we put our efforts in getting involved in investments, all kinds of investments.

Why should I sit down and say, OK, no. If it is not 936, it is only what Chairman Pickle wants in relation to Puerto Rico, only those 936 funds, I will not touch it. No. We have gone all the way. I have gone to all of those islands. We have had seminars in all of those islands showing the importance of 1936, showing the importance of signing the tax information exchange agreement. And we have been successful. That is the reality.

I will, you know, I ask you really to have someone from your staff work with us on a continued basis so that you will realize then the amount of efforts that have been done. And the result that we are getting.

Chairman PICKLE. Thank you, Mr. Colorado. Now, I want to call on Mr. Rangel, but I will say to you that members of our committee will be working with you, and will be involved.

Mr. COLORADO. Thank you very much.

Chairman PICKLE. Mr. Rangel.

Mr. RANGEL. Mr. Chairman, let me thank Mr. Anthony for his line of questioning where he has emphasized his deep support for the Caribbean Basin Initiative. I think that he has hit the heart of

this problem, and that is for our Caribbean Basin Initiative it seems as though we have turned it over to the 936 companies and the government of Puerto Rico.

We have actually said that a bunch of Puerto Rican bankers should determine what investments are going to be made in these countries. That is why you and I are both frustrated, that we don't see small businesses and individuals in Jamaica and others coming and getting these loans. And, then we have thrown on top of that our Treasury who are now insisting that tax information tax treaties and regulations be followed.

Now, what I do not see, because I am disappointed too, is where is the American foreign policy? I mean I know that the Puerto Rican government has made you secretary of state of Puerto Rico. But where is our Secretary of State? Who do you work with? What are you doing in Panama—I mean were you a part of the invasion forces? I mean why are you there getting these treaties into place, and how do Puerto Rican bankers determine which countries in the Caribbean are in our best national security interests to get grants and loans?

It seems to me that we are letting our frustrations out on the wrong entity. Our Treasury Department could not tell me who is in charge overall of the economic development of Puerto Rico. And I assumed if he could not do it for one of our possessions, he darn sure could not do it for a foreign country.

So, let me start from the beginning. Is there a U.S. National Economic Development Program for the government of Puerto Rico?

Mr. COLORADO. Not that I know.

Mr. RANGEL. Is there any other economic development program that comes from the mainland to create jobs in Puerto Rico with the exception of 936?

Mr. COLORADO. In Puerto Rico or in the Caribbean?

Mr. RANGEL. I am talking about Puerto Rico because they are not asking for statehood yet.

Mr. COLORADO. No.

Mr. RANGEL. Now, how many jobs do the Puerto Rican government attribute are created directly or indirectly by the 936 program?

Mr. COLORADO. From 100,000 to 120,000 direct manufacturing jobs.

Mr. RANGEL. What percentage of the Puerto Rican employment is attributed to 936?

Mr. COLORADO. That would be about—direct jobs, if we are talking about direct jobs, that would be about 12 to 14 percent of the total labor force.

If you add the indirect jobs, it would be about probably one-third of the total labor force, and about half of the nongovernmental labor force.

Mr. RANGEL. Now, under what——

Chairman PICKLE. Mr. Rangel, I think that is right, the 10 or 12 percent, whatever he said.

Mr. COLORADO. Direct jobs of the total labor forces.

Chairman PICKLE. I think it ought to be observed also that it is also costing the United States about $2 billion for that.

Mr. RANGEL. Well, I wish we can find out how that cost is ascertained. Do we lose $2 billion in taxed in Puerto Rico as a result of the 936 program?

Mr. COLORADO. No. This is something that keeps being said and people are beginning to say——

Mr. RANGEL. How did we lose what we never had?

Mr. COLORADO. No, and what you will never have, what you will never have because if those companies are going to be taxed, they should be taxed where they make their income. And they make their income in Puerto Rico, and Puerto Rico is the taxing jurisdiction. Puerto Rico taxes it. Then no income. We have come to the Federal Government.

So there is nothing further away from the truth than establishing the cost to the United States of $2 billion.

Mr. RANGEL. Well, listen, I think we have a moral and political obligation to either come up with a better program or improve the one that we have. So, no matter what it costs, unless we have a job development program for our citizens in Puerto Rico, I think that Treasury said that this is what we have to work with.

Let me swiftly move into the foreign policy since all of us are concerned about these Caribbean countries.

Is it your testimony before this committee that the government of Puerto Rico has no grant money or no appropriated money to issue to Caribbean countries in order to improve their economy?

Mr. COLORADO. The benefit of section 936 to Puerto Rico is for the economic development of the island in the private sector. So all of the benefits go to the private sector and, therefore, that creates economic development in Puerto Rico and——

Mr. RANGEL. The only funds that you have that we are discussing today are funds held by Puerto Rican banks.

Mr. COLORADO. Right. That is where the 936 funds are.

Mr. RANGEL. And the moneys that they give to loans are subject to the same banking regulations as any other bank?

Mr. COLORADO. They are all covered by the Federal laws of regulation.

Mr. RANGEL. So, regardless of what your commitment is, it is to encourage and to facilitate these bank loans?

Mr. COLORADO. I mean when I say we do not give grants, I am saying we do not give grants of any substantial amount. We give scholarships and we give other types of help to many of these countries.

Chairman PICKLE. Mr. Rangel, would you be kind enough to yield to the Chair? I would like to recognize Mr. Levin who has a question he would like to ask. And he has to go to a luncheon to make a presentation. And then after he asks the question, Mr. Rangel, I will yield back to you then.

Mr. Levin.

Mr. LEVIN. I deeply appreciate it, Mr. Chairman, and you, Mr. Rangel, thank you. I will be brief as one who is a member of the full committee, but not this subcommittee.

I wonder, Mr. Colorado, if I might just take a brief moment to ask you about a subject that is of increasing concern to us, the graduated excise tax on automobiles, which for a time had some

substantial direct involvement with 936 through the financing of automobile purchases. Now, that connection is not so direct.

But let me ask you, are you aware of this issue now from——

Mr. COLORADO. Yes, sir, I am, yes.

Mr. LEVIN. When the Governor was here a few months ago, just last month actually, he was asked about an industry report, and was requested to have a response to us by the first of the month, of this month. We have not heard back from the Governor.

Do you have any idea when we are going to receive comments? I have a copy of the report and have read it the best I can. Do you have any idea when we will be receiving a response?

Mr. COLORADO. I have no idea. I can assure you that I will take care of the matter as soon as I come back to Puerto Rico—I go back to Puerto Rico.

I know what the issues are. As a matter of fact, I met with one of the representatives of the Automobile Manufacturers Association here some time ago. They did not call on me again. But I remember that they discussed this matter with the then Secretary of Treasury.

Now, if there was a Secretary of Treasury, probably that has delayed the whole thing. I appreciate very much what you intend to do. I plan to, you know, get this thing in such a way that helps more the U.S. company. We are in agreement. There is nothing against that.

As a matter of fact, when this was prepared, we weren't buying Japanese cars. This was a very, very long time ago. It was just a matter of trying to get the cost of the cars and the weight on the roads reduced as much as possible.

I believe that could be changed. I know that the position of our government is favorable in that sense.

Mr. LEVIN. Well, let me just finish by saying we have learned favorable positions do not mean much if they are not implemented. The present U.S. car manufacturers' share of the market within a part of the United States, Puerto Rico, is now less than 20 percent.

You have a system that clearly works against automobiles with the same sales price as made elsewhere if they are made in the United States.

Mr. COLORADO. No. No, that is not the way it works.

Mr. LEVIN. Well, the sales price can be the same if the weight is different. All right.

Mr. COLORADO. That has nothing to do with where the car is made.

Mr. LEVIN. I know. That is the problem.

Mr. COLORADO. That is a problem of how the cars are manufactured. But obviously our intention was never that.

Mr. LEVIN. Well, but that has been the effect.

Mr. COLORADO. That has been the effect.

Mr. LEVIN. All right. We want an answer. As a member of this committee, and I am not the only one, I want an answer soon.

So I will expect—when do you return to Puerto Rico?

Mr. COLORADO. This afternoon.

Mr. LEVIN. This afternoon?

Mr. COLORADO. Yes, sir.

Mr. LEVIN. Do you think there is a chance I can hear—when do you think I can hear from you just as to the status of the answer?

Mr. COLORADO. I can get to the Governor as soon as I get there, and I will——

Mr. LEVIN. Do you think by Thursday noon you can at least call me?

Mr. COLORADO. I can all you.

Mr. LEVIN. OK. Good. Thank you.

Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Rangel.

Mr. RANGEL. Thank you. I would like to conclude.

Mr. Colorado, I think it is very important that we dramatically show the number of jobs that has been created as a result of the 936 program. That is primarily what we are talking about so if your office can provide something for this committee directly and indirectly, that will be appreciated.

I think that we have put too much of a burden on the government of Puerto Rico as it relates to the economic recovery of the Caribbean Basin. And I would like to know who in our State Department works directly with you as you visit these Caribbean countries in order to facilitate their development?

Mr. COLORADO. Well, Mr. Congressman, I have to tell you that, on the one hand, we have had very good continued communications with some of the personnel in the Department of State, as well as in the Department of Commerce.

Mr. RANGEL. I know. But I mean is this——

Mr. COLORADO. No.

Mr. RANGEL. The U.S. Secretary of State, do you work with assistant secretaries of States or what?

Mr. COLORADO. I have asked for something to have a policy group at least at the level of assistant secretaries, that could sit down together for a number of, you know, few hours ever so many months, and address these issues so that we can work together, which is what we want to do.

Mr. RANGEL. Mr. Chairman——

Mr. COLORADO. We have not been able to obtain that.

Mr. RANGEL. Mr. Chairman, I hope that we can encourage our Trade Subcommittee chairman, Mr. Gibbons, to have joint hearings with us so that we take a look at what—Mr. Chairman——

Chairman PICKLE. Yes.

Mr. RANGEL. I hope we can encourage some joint hearings on what is happening in the Caribbean because I think that 936 twin plant is an essential part of being of assistance to the Caribbean. But it certainly is not everything. And I would hate for our Caribbean friends to be dependent on just this program.

And so I will ask you to see whether or not we can have meetings with Mr. Gibbons. And I yield back the balance of my time.

Chairman PICKLE. Whether you would have any joint hearing would depend on the chairman, Mr. Rostenkowski. He is not here at this meeting.

Mr. RANGEL. Well, if I have your support, I am certain we can do it, Mr. Chairman. Thank you.

Chairman PICKLE. If I think we should consider that, I would think about it.

Mr. Guarini.

Mr. GUARINI. Thank you, Mr. Chairman.

Mr. Secretary, Mr. Colorado and Mr. Sosa, as Americans, you are on center stage, and Puerto Rico has a unique opportunity with the good standing in offices they have with the other countries in the Caribbean Basin. It is a great plus and a great moment to be able to be of great help in our foreign policy. I know you have gone through a great deal of frustration between the TIEA, the regulations and all the other problems that you have experienced.

These last 3 or 4 years perhaps have been very difficult but, hopefully, the future will be a lot clearer and a lot easier.

I understand from Mr. Gideon that there is great deal of hope being put into a new institution that you have founded by your legislation: the Caribbean Basin Financing Authority. He seemed to rely upon this as being a way of breaking the deadlock in regard to these guarantees and being able to get section 936 loans through.

Could you comment on that and how that will help us, and how effective will this institution be?

Mr. COLORADO. The basic purpose of that entity is not to guarantee loans. And though it may do so, and the law permits it to do so, or authorizes it to do so, basic at least to review the cost of the issuance of loans in the Caribbean.

We have a similar institution in Puerto Rico called EFRICA that has served that purpose for the last 13-14 years. And it has been very successful in issuing bonds for specific loans in Puerto Rico, complying with all of the requirements. And that cost of processing is lower.

That is the main purpose of what we are doing, is trying to see how we can deal with projects like the ones that were mentioned here, and make them substantially more economical to this process.

Now, it can give loans and it can guarantee loans from we know its own sources. So, once we start generating some income, there is the possibility of going into smaller loans and smaller projects where some kind of piece would not be available outside, and we can sort of give part of a guarantee, and somebody else would give part of the other.

We are very involved and try to look at alternatives in this area. This is something that we are structuring right now. So we have to start it carefully and see how it can work.

I think it is going to benefit our program.

Mr. GUARINI. Would it help to make 936 more workable——

Mr. COLORADO. Yes, it will.

Mr. GUARINI [continuing]. In guaranteeing these loans because in the statement, I quote, "The future success of section 936/CBI program may depend upon the Caribbean Basin financing authorities' ability and willingness to provide guarantees for section 936 loans."

Is this an overstatement?

Mr. COLORADO. I disagree with that in the sense that it can be an important factor. What is going to make successful the use of the funds and the growth in the Caribbean as far as our program is concerned, No. 1, is getting more countries to sign the tax information exchange agreement. And they will do so once they see what is happening in Trinidad and Tobago, what is happening in Jamaica,

and what is going to happen in the Dominican Republic, with the use of the funds.

I think we can get Costa Rico to sign, to ratify, and we may get some of the other countries.

Now, in addition to that, what is also very important is what the financial institutions are doing. The banks are getting much more involved now than they were before. And right now you will see that many of the banks are working with $200, $300 million in projects.

So it is going to happen, you know, and we have seen how it has grown in the last 3 to 4 months, And it has been because of the result of everything that was done in the first 2 or 3 years.

Mr. GUARINI. The question before us, of course, is how do we get 936 loans through. Now, do you come at all with any specific regulations to the legislation that we have to recommend anything as to how we can expedite the loans, things that we here in Congress can do, so that we can work with you in a cooperative way?

Mr. COLORADO. Yes, as part of my testimony I gave a copy of my presentation in the hearings that were held for the regulations. There are a number of issues which are important and one of the issues, obviously, is privatization. You take a country like Jamaica, I think privatization is very important in that area and is something that goes with U.S. policy and the policy of, in this case, Jamaica.

The same thing would be true, for example, in Panama or in Nicaragua in the near future, so privatization is an area which I think is very important and should be included in the regulations.

What we hear from Treasury is positive in that sense. They say that they are considering it, they are trying to draft it in such a way that it will be beneficial.

There are a number of other matters in the regulations that we believe at this time should be as flexible as possible, so that we can get this thing moving much faster. Later on, we can direct more here or there.

For example, where we are talking about the planes from Jamaica, if the planes were built somewhere else—I have heard so many times, even people in Congress, have complained about other countries from far away coming into the Caribbean just to finance what they sell. I hope we do not do the same thing. I hope we are flexible and we are willing to help these countries finance what they need, not necessarily what we sell.

Mr. GUARINI. Well, since tourism is a foreign exchange earner and many of the countries are dependent on tourism, would we expect 936 funds to be used for possibly the building of hotels in these countries?

Mr. COLORADO. We have given two loans already. Congressman, we have given already, two loans have been approved for a hotel in the Virgin Islands and for a hotel in Jamaica.

Mr. GUARINI. For 936 funds?

Mr. COLORADO. For 936 funds.

Mr. GUARINI. Therefore, you are moving, even though it would be competitive with you——

Mr. COLORADO. I would be competitive, but I believe the Caribbean as a whole is what we have to look at. I think a hotel in Jamaica does not hurt Puerto Rico.

Mr. GUARINI. I agree.

Mr. COLORADO. On the contrary, it makes the Caribbean better known and then you give choices to people who come from Europe to stay a few days in Puerto Rico and a few days in Jamaica, so it makes the whole area more attractive. So, I do not think there should be any concern in that area.

Mr. GUARINI. I agree.

Just one last question, if I may. Pharmaceutical companies are putting together 936 funds to create a CBI fund of their own for investment. What is the status of that?

Mr. COLORADO. I think we will have representatives of the Puerto Rico Finance Foundation later on and they can go into the details.

Mr. GUARINI. Thank you.

Thank you, Mr. Chairman

Chairman PICKLE. I thank you, Mr. Guarini.

I might add that I was privileged to attend the breakfast you had this past week with a Caribbean tourist group and at the breakfast, as I recall, the suggestion was made to the group that we should not concentrate on tourism to the extent that we just build more and more hotels and more and more facilities, because pretty soon there is going to be nothing there but tourism and we have got to think in terms of jobs, business. They cautioned us not to just participate in everything to just build more hotels, but also look for jobs and that was a good observation and I am glad you held that breakfast, Mr. Guarini, because that is an emphasis that must take place.

Thank you, Mr. Guarini. I am glad that you could join us this morning and I appreciate your questions and your indulgence.

Mr. GUARINI. Thank you, sir.

Chairman PICKLE. Mr. Colorado, I have a few other questions to ask you. First, to kind of follow through on your question earlier, you said that Puerto Rico should be given credit for these various loans, even if they are made directly by the companies and not through 936 funds.

I would not agree that that is a logical, but that is your position.

I want to know, if you get credit for the 936 funds directly invested by the companies, what incentive is there for you in Puerto Rico, then, to loan or disburse $100 million or $200 million?

Mr. COLORADO. Puerto Rico does not loan any money. Puerto Rico does not disburse any money.

Chairman PICKLE. From the 936 funds——

Mr. COLORADO. From the 936 funds, we do not disburse or loan any money from 936 funds. The private institutions do.

Chairman PICKLE. Then, Mr. Colorado, you do not have to do anything. If the companies get the credit, then you really do not have to do anything, do you?

Mr. COLORADO. I can assure you that what has happened in the Caribbean in the last part of it——

Chairman PICKLE. Well, I am not saying that you will not, I am just saying you would not have to do it if we give you credit for all of these loans.

Mr. COLORADO. If we do not do it, it will not happen.

Chairman PICKLE. Now, Mr. Colorado, just for the record, I want to talk now about the projects that are actually funded under 936 and funds are actually disbursed. In your testimony, you said there is $200 million in 936 loans that have been disbursed.

Mr. COLORADO. No, I do not think so.

Chairman PICKLE. Now, that is your testimony.

Mr. COLORADO. No, I did not say that.

Chairman PICKLE. In your appendix, in your own appendix, I count only six of these projects, totaling $102 million. Now, I show——

Mr. COLORADO. Congressman, I do not say that anywhere here. What I say is that over $200 million of the amount of projects that I am accounting for have been disbursed. That is what I say there. I do not say that they are 936 funds.

Chairman PICKLE. Then the record ought to show that we have actually funded the ABC Container for $22.1 million, the Seaboard project for $18 million, the Jamaica housing for $8.7 million, Air Jamaica for $51 million, AT&T $17 million and Rose Hall for $6 million. That is as total of $102 million, not $200 million, but only $102 million, so the record will show that it is actually $102 million. Is that not correct?

Mr. COLORADO. No, that is not correct.

Chairman PICKLE. All right. Now, can you briefly or quickly——

Mr. COLORADO. Yes, I will briefly. There is another loan——

Chairman PICKLE. I hope that your answer would be as succinct as you can make it——

Mr. COLORADO. No, no, no. What I am saying——

Chairman PICKLE [continuing]. Because these are facts that we are talking about.

Mr. COLORADO. Congressman, what I am saying is, when I mentioned $200 million, I was mentioning all of the investment that had been done is over $200 million, not 936 funds necessarily. Now, the amount——

Chairman PICKLE. Well, I accept what you said you intended, but actually it is only $102 million now of the projects that are approved, but not closed. We have a list of them here and I will read them: $4.5 million to Abbott Laboratories, $13 million for Barbados Telephone, $79 million to Caribbean Methanol, $66 million for Phoenix Hall to build a natural gas plant, $9 million for a hotel project in the Virgin Islands.

Then you have got an unidentified loan of $31 million and you say it is an unidentified loan. What is that?

Mr. COLORADO. This is a project in Trinidad Tobago.

Chairman PICKLE. I beg your pardon?

Mr. COLORADO. It is a project in Trinidad Tobago that is being worked with and it has been approved, but they are trying to keep it confidential for the time being.

Chairman PICKLE. Who are they? What is the project? Why do we have an unidentified project?

Mr. COLORADO. Because it has not been disbursed yet, it has not been completed yet.

Chairman PICKLE. Well, six of these others have been identified and we know what they are looking for, but here you have got an identified——

Mr. COLORADO. Because some companies do not mind that you disclose their projects and some of the companies do mind until it has been done. That is the only reason.

Chairman PICKLE. You mean you have got an unidentified loan, they are seeking $34 million, and you cannot tell the government or anybody else what that is, who that is?

Mr. COLORADO. No, they do not want me at this time to mention the case. I can tell you we have the project, I can tell you the banks are working on it, I can tell the staff, if you want me to, later on.

Chairman PICKLE. Well, you say these funds are confidential. Are they confidential at the request of the borrower?

Mr. COLORADO. Yes.

Chairman PICKLE. And you cannot tell us who they are?

Mr. COLORADO. I cannot say here. I can tell your staff later on.

Chairman PICKLE. Is that normal for any company to come in say I want to borrow a lot of money, but I do not want anybody to know about the closing of a $30 million loan?

Mr. COLORADO. It is very normal, yes, sir.

Chairman PICKLE. Very normal?

Mr. COLORADO. Oh, yes, companies do not want that until it is done.

Mr. SOSA. If I may comment, this situation stems form the private nature of these transactions. If these were loans funded directly by the government, we would not have any problem in disclosing that information, but this is strictly private transactions.

Chairman PICKLE. Well, we have rumors of what that is about and I do not understand why it should be confidential to everybody for $31 million involved until it—just assuming that is the procedure, when will we know——

Mr. COLORADO. No, I am sure your staff——

Chairman PICKLE. When will the public be entitled to be informed of that one?

Mr. COLORADO. I am sure your staff already knows, but if they do not, we can give the names. Now, immediately before it will be disbursed, it will be known.

Chairman PICKLE. Well, these projects are under consideration, they are not closed, but they may do it now. May I ask you, Mr. Colorado, just because——

Mr. COLORADO. Mr. Chairman, let me add to the numbers, because you were asking me about the numbers and I want to give you the correct numbers. Now, to those numbers that you have, you have to add the Phoenix Park project, that is $56.5 million which you were not counting, plus the Abbott Laboratories, which is $4.5 million. Those funds are already being disbursed, so they have to be added to the $102 million that you mentioned.

Chairman PICKLE. If you have later figures, we would like to have them, no question. But my record as of last week had this information.

Mr. COLORADO. I know, Mr. Chairman, but these change every day.

Chairman PICKLE. You have approved at FOMENTO a lot of these other loans, but do we know that these loans will ever be closed and disbursed?

Mr. COLORADO. Which loans?

Chairman PICKLE. These last six that we are talking about now that have been approved for financing but not closed, we know that they will be closed?

Mr. COLORADO. Two of those, as I said, have been closed already. The others are very close to being closed and all of them should be closed——

Chairman PICKLE. I accept the fact that you say that two of them have been closed, but there is no assurance that the other four will be closed, is there?

Mr. COLORADO. There is no assurance, but we have come to the point where we believe it is very clear that they will be. Now, one of them may fall, but we have four or five more that are in the process also which are not there.

Chairman PICKLE. Well, did you not have a——

Mr. COLORADO. I can assure you that if things continue the way they are, before the end of the year, we will have more than $500 million.

Chairman PICKLE. Is it not true, Mr. Colorado, that you had a $13 million loan to the Barbados Telephone Co. about a year and half ago and still no funds have been disbursed to it, is that correct?

Mr. COLORADO. The approval of a loan by the Government and by Treasury does not mean in any way that the loan is going to be granted and that they are going to find the required things to get the loan. That loan now is being granted, because they changed the structure together along the way. Originally, Barbados had taken the position that they would not take it. Now, they changed in the last 2 or 3 months and now they are going to use those $13 million.

Mr. SOSA. Once more, it is a private decision.

Mr. COLORADO. The decision is not ours, you know, they have to get what they need.

Chairman PICKLE. Mr. Sosa, did you wish to make a statement there?

Mr. SOSA. I am sorry, Mr. Chairman, I was pointing out that it is the borrowers' and the lenders' decision, it is a strictly private transaction, so our approval just clears the way for closing of the transaction. But if the parties to the loan feel otherwise, it is their prerogative.

Chairman PICKLE. Well, we are going to submit questions to you with regard to some of these specific projects and we will expect a written response from you——

Mr. SOSA. Sure.

Chairman PICKLE [continuing]. Not just on Air Jamaica, but several of the others.

Mr. COLORADO. I will be glad to answer all the questions your committee poses.

Chairman PICKLE. Before I proceed, let me ask if either Mr. Schulze or Mr. McGrath have additional questions to ask at this point, then I will come back.

Mr. SCHULZE. Just one question along your line of questioning, Mr. Chairman.

Gentlemen, have any of these loans been concluded or approved or finalized in the last day or 2 or 72 hours?

Mr. COLORADO. None of those——

Mr. SCHULZE. In your testimony, some of them you say are pending and now you are saying that they are disbursed. The funds have been disbursed for Phoenix Park, Abbott Laboratories.

Mr. COLORADO. I mentioned to the Chairman before that there were two cases that we understand they have been closed, one of them has been closed and the other one, interim financing has been done, which I mentioned to you.

Mr. SCHULZE. Just in the past day or so?

Mr. COLORADO. No, just in the past probably 10 days, yes.

Mr. SCHULZE. The past 10 days.

Thank you, Mr. Chairman.

Chairman PICKLE. I did not hear the response, but I believe you understood that, in the last 10 days, roughly two of those have been approved.

Mr. COLORADO. More or less, yes. I say more or less, because I do not know if it is 10 days or 110 days or 12 days. One of the important ones in Trinidad Tobago was completed within the last 2 weeks, which is a big one, an important one.

Chairman PICKLE. I make the personal observation now that it would appear to me that there is a great deal of activity in approving these 936 loans now, that you are making contacts and saying "Please don't you want to use some of these 936 funds?" We did not have but three closed by the end of 1989 and now there is a great deal of activity, a flurry of activity and I wonder why.

Mr. COLORADO. No, no, no, no. Mr. Chairman, please, let me answer that, because it is not true. First, we were negotiating with Trinidad Tobago for 2 years to get their approval of the tax information exchange agreement. It was not until February 8 or 9 that they did it.

Chairman PICKLE. Well, Mr. Colorado, you had a tax treaty with Jamaica and——

Mr. COLORADO. Yes, but we do not create——

Chairman PICKLE [continuing]. What is the other one, with Jamaica and——

Mr. COLORADO. Right.

Chairman PICKLE. You had two of them and in 3 years you made two loans.

Mr. COLORADO. For 3 years——

Chairman PICKLE. Two, for 3 years, that is all.

Mr. COLORADO. Congressman, as a matter of fact, our efforts at the beginning, 2 years ago, 3 years ago, has been as hard or harder than what we are doing now. The problem is that we had no regulations and many of these things had to be understood. The Air Jamaica case was a breakthrough, yes. It was not the best of cases in the sense that it was very difficult, but it showed the people that it could be done. So, once we did Air Jamaica, other cases started working.

There is no way that you get a manufacturing company to establish a project in a country that does not take you from 1 to 2 years.

Chairman PICKLE. Mr. Colorado, I do not want to appear to be argumentative with you or be negative about it, but when you say you are processing the things and we are working hard and have all these years, here are some nations like Jamaica and Grenada, we have got several of them, a tax treaty, and you have only approved two of them. In Jamaica's case——

Mr. COLORADO. We approved what came.

Chairman PICKLE [continuing]. AT&T and Air Jamaica. Now, I approve of——

Mr. COLORADO. No, we had a housing project that we approved.

Chairman PICKLE [continuing]. But I do not know what good effort you really have been making.

Mr. COLORADO. We have been making a very, very strong effort in all of these islands. As a matter of fact, we approved long before that a housing project in Jamaica and we have approved other projects.

Chairman PICKLE. Now, Mr. Sosa, you said there is some $200 million in 936 funds that are in the Government Development Bank.

Mr. SOSA. That is correct, $248 million.

Chairman PICKLE. Have you made any grants from those funds, any loans form those funds?

Mr. SOSA. Once again, we come back to the way the 936 funds work. If the Government Development Bank were to make grants out of these funds, how would the bank be able to repay these deposits? The only thing that the GDB would do would be to grant loans and it has done so, so grants are not part of the use of 936 funds.

Chairman PICKLE. Mr. Sosa, the fact of the matter is, though, that you have got $200 million at least down there in governmental funds, GDB funds.

Mr. SOSA. Yes, actually invested in eligible activities.

Chairman PICKLE. Those funds have not been disbursed, they are there and——

Mr. SOSA. No, no, no, no. They are——

Chairman PICKLE. There have been no loans made.

Mr. SOSA. These funds are backing eligible loans granted by the Government Development Bank. The Government Development Bank has originated Over $1.3 billion in eligible loans, so these funds are not sitting there idle.

Chairman PICKLE. Well, are you saying that no loans of section 936 funds to the other CBI countries have been made by the Government Development Bank?

Mr. SOSA. Yes, the Government Development Bank granted an $8.7 million housing project, a loan for a low-income housing project in Jamaica. Actually, the Government Development Bank was——

Chairman PICKLE. Well, tell me, what loans—if you said loans have been made—what loans have you made from the Government Development Bank?

Mr. SOSA. In the Caribbean?

Chairman PICKLE. Yes.

Mr. SOSA. This Jamaica low-income housing project. It is $8.7 million.

Chairman PICKLE. All right. You say that is one.

Mr. SOSA. Sure.

Chairman PICKLE. And where was that made, in what country?

Mr. SOSA. Jamaica.

Chairman PICKLE. In Jamaica.

Mr. SOSA. And as I was mentioning——

Chairman PICKLE. And that is a low-income housing loan.

Mr. SOSA. As I was mentioning, the GDP was the pioneer in beginning the flow of 936 funds into the Caribbean. This is——

Chairman PICKLE. Well, how did you approve the one to Jamaica, then? Why was it approved?

Mr. SOSA. I beg your pardon?

Chairman PICKLE. Why was it approved, the one to Jamaica?

Mr. SOSA. Why was it approved?

Chairman PICKLE. The housing.

Mr. SOSA. I am sorry, I did not understand the question.

Chairman PICKLE. On what grounds did you approve that? You say that was one loan that was made by the Government Development Bank.

Mr. COLORADO. Let me answer that one, if I may, Mr. Chairman, because I was involved from the beginning. This was a request that we got from Jamaica. The Prime Minister of Jamaica, at that time Prime Minister Scaga, requested from the Governor that what he wanted in Jamaica more than anything else was for us to be able to finance some housing for his teachers, for his policemen and for his nurses and that is what we did, and $8.7 million were invested in housing that they were able to give, because of the low interest, that they were able to sell to these types of people without a downpayment.

Chairman PICKLE. Has it not been the policy of the GDB that you make loans only if it improves jobs and helps create jobs in Puerto Rico?

Mr. COLORADO. This one created jobs in Puerto Rico, because the basic parts of the building were produced in Puerto Rico, they were shipped to Jamaica and put in place in Jamaica.

Chairman PICKLE. Well, was there some question of whether it created jobs or helped Puerto Rico in the process?

Mr. COLORADO. It created jobs in both places.

Chairman PICKLE. So, that is the one instance that it then met the policy you had, that it had to help Puerto Rico, you would not make the loan?

Mr. COLORADO. That one——

Chairman PICKLE. Is that not correct?

Mr. COLORADO. That is when the policy was made.

Mr. SOSA. You must remember, this complementary nature, the creation of jobs in both the CBI country and Puerto Rico, is required of the loans generated by the Government Development Bank only. Because of its charter, the bank cannot grant loans in the same way a private bank can. This complementary requirement does not apply to loans granted by private banks.

Chairman PICKLE. I do not want to dwell on this, but it seems to me you said yes, you have been making loans and you give me one instance and then you tell me that it did help jobs in Puerto Rico and that is why you approved it.

Let me ask you another question. Did the Treasury ever approve that loan?

Mr. COLORADO. No, it did not.

Chairman PICKLE. It did not.

Mr. COLORADO. No.

Chairman PICKLE. Then why are you claiming it?

Mr. COLORADO. It does not have to be approved by Treasury for us to claim it.

Mr. SOSA. Even Mr. Gideon mentioned that.

Mr. COLORADO. Even Mr. Gideon mentioned that here, that it did not require the authorization by Treasury. He said that here.

Chairman PICKLE. Well, I do not want to be——

Mr. COLORADO. As a matter of fact, you argued about it.

Chairman PICKLE. It just seems to me like we are getting half the story.

Mr. COLORADO. No, no, no, you are getting the whole story. You do not need the approval of Treasury for every loan and now, under the regulations, you do need it, either.

Chairman PICKLE. All right.

Mr. SOSA. Sir, if I may make one comment, the need, you could say, of having a no-objection letter from Treasury stems from a private bank's concern of being in full compliance with the statutory provisions of 936(a)(4). Being the GDB a government bank, the GDB does not have that fear that its actions may have an adverse impact on its clients or depositors, because it does not have that relationship.

If I may impose on the chairman, we have been talking here a lot about the so-called $100 million commitment. If, for argument's sake, we were to accept that Puerto Rico made the commitment to get $100 million annually invested, that commitment came up at a moment in which Puerto Rico was considering the possibility of investing funds in the whole Caribbean. Then at the moment that we only have 4 countries eligible for receiving 936 funds, we should proportionately allocate the amount of funds that can be lent, and if we do that, 4 out of 22 is a proportion that would require $18 million of annual investments, and you multiply that by 3 years and you get $54.5 million. Certainly, we have $70 million in loans during these 3 years.

So, in all fairness, if we are to talk about the $100 million commitment, I think we should also be talking about the limitation imposed by Treasury's recommendation of only allowing funds into TIEA signatory countries.

Chairman PICKLE. I am sure Treasury will keep these matters in mind and we will be hearing additional testimony and I would like to get their response to the point you made and I can see why you make the point. But we will be looking into that further.

Mr. SOSA. Surely.

Chairman PICKLE. I want to thank both of you. We have got other panels to be heard from and we must move on. I thank you for coming and presenting your testimony. Thank you very much.

Mr. COLORADO. Thank you, Mr. Chairman.

Mr. SOSA. Thank you, Mr. Chairman.

Chairman PICKLE. Now, the next panel will be a panel consisting of Mr. Jaime Alvarez and Mr. Asgar Ally. Mr. Alvarez represents

the Embassy of the Dominican Republic and Mr. Ally the National Investment Bank of Jamaica.

This panel consists of Mr. Jaime Alvarez, he represents the Embassy of the Dominican Republic. Mr. Alvarez, and then the other is Mr. Asgar Ally, the trade commissioner of the National Investment Bank of Jamaica.

Let me say to both of you that your testimony, your entire statement will be made a part of the record.

Mr. Alvarez.

STATEMENT OF JAIME ALVAREZ, COMMERCIAL COUNSEL, EMBASSY OF THE DOMINICAN REPUBLIC

Mr. ALVAREZ. Mr. Chairman and members of the committee, I have to say that the Dominican Republic appreciates the partnership with Puerto Rico. With cooperation with Puerto Rico, the Dominican Republic has got more done, 50 percent of the projects that come to Puerto Rico and the Caribbean Basin under 936, under the twin plant projects, but the Dominican Republic has not shared the benefits of 936 funds that it had expected.

According to the Caribbean Development Office, through January 1990, $274 million of 936 funds have been approved in CBI eligible countries. Of that, $149 million were allocated to Trinidad, $51 million and $70 million to Air Jamaica and Trans-Caribbean Cable, and $18 million to Seaboard in the Dominican Republican.

It is the Dominican Republic's opinion that this was not the projects that were expecting. Assuming also, I realize that leaves $40 million to be allocated among projects in more than 20 beneficiary countries. That does not leave any space for smaller or medium-size projects that are the projects that we are looking for.

The 936 package is not a very attractive one for Dominican projects. It is Libor minus 0.2 and the investors investing in the Dominican Republic will have to assume the exchange risk, so it does not seem to me that it will bring a lot of investment to the Dominican Republic as the project is right now.

Dominican businessmen have complained of the slow and cumbersome process to obtain 936 funds. No company, they argue, will submit a proposal if changes for approval are slim. Fomento, on the other hand, says that not a lot of proposals have been submitted by the Dominican companies. It seems like somehow this vicious circle has to be broken down. Otherwise, chances of getting projects in the Dominican Republican are very slim.

Most of the companies that have come to the Dominican Republic under the twin-plant concept have brought their own money or their own financing. The impact of 936 funds in the Dominican Republic has been almost null, but awareness among the business community is increasing. An improvement in the 936 program will broaden the use of the funds and will contribute to spread free enterprise in the region.

Companies operating in Puerto Rico have decided to bring complimentary operations to the Dominican Republic, due to the incentive package the country offers. Competitive wages, disciplined labor force and a positive business environment have attracted U.S. corporations to the Dominican Republic. Adding availability of fi-

nancing to the incentive package will assure increased possibility of the Dominican Republic for development.

The suggestion the Dominican Republican thinks will improve the 936 fund package will be, first of all, to establish a Caribbean fund that can be used for Caribbean companies who do not have collateral in the United States; second, a straightforward route open to companies who have the funds, to use the funds; and, third, funds should be made available in small amounts, given that most of the projects in the Caribbean are small projects lacking financing. The criteria for small projects in the Dominican Republic is not the same as the criteria for small projects in Puerto Rico.

The Dominican Republic has no problem whatsoever with the 936 fund program as it is. The Dominican Republic has benefited a great deal from having partnership with Puerto Rico and the Dominican Republic thinks that if something happened in Puerto Rico right now, that will affect a great deal the Dominican Republic as well, as other Caribbean countries.

You might take into consideration that, in order to tap into 936 funds, the Dominican Republic is saying it is asking for an information exchange agreement. Due to that fact, a lot of capital goes from the Dominican Republic to other countries, so that means that the Dominican Republican is lacking financing, sources of financing, because it signed an exchange of information agreement with the United States.

To cut the 936 funds and not have them available for the Dominican Republic may be seen as betrayal on the part of the Dominican Republic.

Thank you very much.

[The statement of Mr. Alvarez follows:]

Testimony of Jaime Alvarez, Counsel of the Embassy of the Dominican Republic Before the Commitee on Ways and Means, U.S. House of Representatives on Section 936 of the Internal Revenue Code

In the percent past economic relations between Puerto Rico and countries beneficiaries of the Caribbean Basin Initiative have increased. Under the complimentary operations program more than 78 projects have been approved, totalling an investment of $357 million. These projects have created more than 12 thousand jobs in CBI countries and more than 3 thousand in Puerto Rico.

In 1986 the US Congress made available to CBI countries funds held in Puerto Rico under Section 936 of the Internal Revenue Code. At that time there was strong expectations in the Caribbean countries given that new financing was available for so much needed development projects. Puerto Rico was about to become a better ally in the war on poverty in the Caribbean region.

Before the amendment was made Puerto Rico was already an important trading partner, and an important source of investment for most of its neighbors. For the Dominican Republic, Puerto Rico is not only the most important trading partner in the region, but also is the island that has shared with the Dominican Republic the strongest cultural ties.

In recent times the Dominican Republic has developed a positive approach toward foreign investment. That made U.S. companies operating in Puerto Rico think about moving labor intensive processes to the Dominican Republic and other countries in the Caribbean while retaining their 936 benefits. That way of production sharing known as "twin plants" or complimentary operations has been very popular among Puerto Rico and the Dominican Republic.

To January 1990 more than one out of two projects of complimentary operations between Puerto Rico and the Caribbean countries were made in the Dominican Republic. 39 (or 42) out of 78 (or 81) projects, depending upon the accounting method, are located in the Dominican Republic.

For this reason the announce that 936 funds were available for financing projects in countries other than Puerto Rico generated great expectation in the Dominican Republic. It was thought that besides from taking advantages of complimentary operations, the Dominican Republic could take advantages of low interest financing as well. Unfortunately this has not been the case for most projects.

According to the Caribbean Development Office, to January 1990 $274.8 million of 936 funds have been released in CBI eligible countries. Of that $149 million were allocated to petroleum refining in Trinidad, $51 million to Air Jamaica, $17 to the Transcaribbean Cable in Jamaica also, and $18 million to Seaboard, a barge destined to contain a floating generator in the Dominican Republic. These are mainly big capital intensive projects with low effect on the level of employment in the countries in which they have been carried out.

As you may have realized that leaves less than $40 million to be allocated among other projects in more than 20 beneficiary countries. The Dominican Republic has only got another project financed by 936 funds, with an investment of $3 million to employ 200 people.

The 936 package is not a very attractive one for Dominican projects. It is Libor minus .2 and Dominican investors have to assume exchange risks. Besides, 936 is designed for companies that have collateral within U.S. territories. That means no small or medium size Dominican project may qualify for 936 funds.

Dominican businessmen have complained of the slow and cumbersome process to obtain 936 funds. No company, they argue, will submit a proposal if chances for approval are slim. Fomento on the other hand says that not a lot of proposals have been submitted by Dominican companies. It seems like somehow this vicious circle have to be broken. Otherwise chances are the use funds by Dominicans will not become broad.

Most of the companies that have come to the D.R. under the "twin plant" program have brought their own money or financing. They have not used 936 funds. The impact of 936 in the Dominican Republic has been almost null, but awareness among the business community is increasing and a more broad use of 936 is likely. An improvement in the 936 program will broaden the use of the funds and will contribute to spread free enterprise in the region.

Companies operations in Puerto Rico have decided to bring complimentary operations to the Dominican Republic due to the incentive package the country offers. Competitive wages, disciplined labor force and a positive business environment have attracted U.S. corporations to the Dominican Republic. Adding availability of financing to the incentive package the region, and as part of the Region the Dominican Republic, will make it more attractive to investors.

SUGGESTIONS TO IMPROVE 936

The Dominican Republic has always been supportive of the idea of having 936 funds available to countries of the Caribbean region. It has always appreciated its partnership with Puerto Rico. Nevertheless it has to recognized that the actual program have failed to reach a broad number of prospective users due to the administration of the program, and due to restrictions in the program itself. For the above mentioned reasons the Dominican Republic thinks 936 has to be enhanced in order to make the funds available to small investors and to reduce the amount of time and work necessary to obtain one of such loans.

936 funds to be used by Caribbean nations can be specialized under a Caribbean Development Fund or Caribbean Financing Fund. CBI countries may have chairs in the board of the Fund, and only the countries that have signed a TIEA with the U.S. may be allowed to vote. Puerto Rico as the source of the funds will be member of the board with veto power over the projects proposed for approval. The fund will operate through specialized development agencies within the government, or through commercial banks of the beneficiary countries.

The use of the fund's money will be open to national of the countries of the Caribbean basin and the amount of the loan in order to qualify will be left to the discretion of the Board of the proposed Caribbean Financing Fund. That will address two of the main problems the program faces at this moment.

936 can be improved by adding to it three components. First, the approval procedure must be streamlined. Short and straightforward rules should be applied. Second, the financing should be open to companies owned by nationals of the CBI beneficiary countries. Third, funds should be made available in small amounts, given that most of the project in the Caribbean are small projects lacking financing. The criteria for small projects in P.R. and in a small island of the Caribbean is not the same. The Dominican Republic has no problem in supporting such a program under the present arrangements with Fomento.

Chairman PICKLE. Thank you for helpful testimony, Mr. Alvarez. Now, Mr. Ally.

STATEMENT OF ASGAR ALLY, PRESIDENT, NATIONAL INVESTMENT BANK OF JAMAICA

Mr. ALLY. Thank you, Mr. Chairman.

I welcome this opportunity to give testimony before this committee on the 936 program.

I come from a small Caribbean economy of 2.3 million people, with a per-capita income of around $1,000 per annum, and with an unemployment rate as high as 19 percent and a very poor distribution of income.

In Jamaica, we have been undergoing very severe economic problems, due to balance of payments difficulties. We negotiated a standby arrangement with the program with the International Monetary Fund to stabilize the economy of Jamaica and to be able to pursue the structural adjustment program to make our economy more market oriented. Our country is a vibrant democracy, but has a fragile economy.

In the context of our experience with this program, we in Jamaica have been, to a large extent, a pioneer in using these resources. Today, what I will do is attempt to answer five questions as to our experience under the program.

The first question is, As it is presently structured, is the 936/CBI loan program of substantial benefit to Jamaica? The actual amount of resources that Jamaica has obtained through the 936 program amounts to roughly $82 million in six projects, of which the Air Jamaica project alone was $51 million and Trans-Caribbean Cable, which indirectly benefits Jamaica, was $17 million. The Wyndham Hotel privatization program was $6 million, and two other apparel and electronics, coming up to $1 million and $85,000, and the Urban Development Corporation low-income housing of $7.5 million.

Jamaica is indeed very grateful to the Commonwealth of Puerto Rico and the U.S. Congress for providing facilities for these resources to be made available to Jamaica.

As the program is currently structured, we have some problems with it and I will discuss this when I deal with the limitations.

The second question, What are the limitations of the program? The program has several limitations. In fact, in the discussions this morning, it was very obvious to us working at that other end of it as it is now, the program really puts on countries like Jamaica the same constraints it has in obtaining loans from commercial banks. The question of sovereign country risk is one which, given the international financial environment and the various rescheduling agreements, makes the 936 program very constrained from day one.

In effect, what is happening is that only large U.S. corporations can really borrow for investment in Jamaica. The small banana plants, as mentioned this morning, the question of the small businesses, there is no way that these companies can qualify for the 936 funds, the way it is programed. I think this is a big concern of ours and we are hoping to work with the Congress, with the Puerto

Ricans and, in line with the Caribbean Basin Initiative, to see what can be done to help greater mobilization of these funds to the Caribbean, especially for the smaller businesses.

In particular, I would like to point out that our country, in particular, is a democratic country and, in that sense, we feel that unless we move it to a greater level of privatization and the small and large businesses are able to survive and have access to capital, then the basis of our democracy can be threatened.

In that context, therefore, we are asking that, in terms of the limitations of the program, the main issue becomes the question of the qualification for loans under this program.

Now, the third question is, What needs does Jamaica have that could be satisfied from the program? There are many needs that Jamaica has in several areas. In particular, we have an bauxite and aluminum industry which can benefit substantially from resources from this program, and already we are in discussions with the Puerto Rican authorities to be able to utilize resources from that program to expand our exports of bauxite and aluminum.

There are the areas of electricity generation, which we are also going to be looking at from the 936 program. There is the question also of the domestic and export agriculture, areas of citrus and orchard crops, in order to be able to export to the American market and other countries.

Jamaica is basically an agricultural country and there are a lot of opportunities for us to be able to expand this production and provide employment for our people. There is the element of low-income housing. Jamaica has as housing gap of roughly 20,000, a shortage of over 20,000 houses at this point in time. We have a very serious problems in low-income housing.

In particular, we find that the program does not really accommodate the privatization of government owned enterprises and, in fact, this is an area which we find inconsistent with the U.S. AID, the World Bank. The IMF, the World Bank and the U.S. AID are encouraging us and we accept that we must privatize, but the resources from the 936 funds do not allow for funding for the privatization program.

We also have opportunities in several areas like food and food processing, shipping, port and transshipment facilities, electronic information processing, garment manufacturing for export, electronic equipment manufacturing and so forth. There is a tremendous amount of opportunity that Jamaica has that need funding from this source.

For the benefit of the honorable Members of the House, I would emphasize that when we look around the world today, the fact of the matter is that aid programs are being reduced substantially, as there are many competing interests shrinkage aid and concessionary resources, therefore, what we find is that for the private sector to expand and grow, the CBI 936 funds become the single most important source of funding in the Caribbean. I would say that for our economies in the Caribbean, and the CBI countries to move forward, this pool of funds is perhaps a beacon of hope for the people in the Caribbean to move forward and to be able to expand their economies.

The fourth question that I would answer is, in our opinion, How have the Puerto Ricans administered the program? I would say the Puerto Ricans have made valiant attempts, especially Secretary Colorado, to get the program moving, but the problems of the program are beyond those of the Puerto Rican government or the Puerto Rican authorities. It is as problem of sovereign country risk and unless that problem is solved, you will find countries like Jamaica, which has as net payout of resources of over $200 million a year, will be unable to move forward, and the Puerto Ricans, because the loans are coming from the banks, would not be able to make loans. Viable projects in Jamaica are being shelved because the financing is just not there, because of the fact that 50 percent of the country's foreign exchange is used to service debt.

Therefore, the private sector is being crowded out, in terms of access to foreign exchange, because 50 percent of what we earn goes to service the debt. I think this is as dilemma which Jamaica and the other countries in the CBI face today.

What changes can be made in the program to facilitate more loans under 936? I think there is a lot of potential in the case of what we have seen in Jamaica for loans to be made. And what are the necessary changes that can take place.

I think, for one, we can, in fact, arrange in a way that guarantee mechanisms can be put in place, as is done by the IDBFC, the International Finance Corporation, and there can be a close collaborative between the Inter-American Investment Corporation, which has just been set up by the IDB, and other agencies in the Caribbean that look to financing for projects.

We in Jamaica pay particular attention to tourism, because, in a way, it is our life blood, it is one of the main sources of foreign exchange and, therefore, we have to be able to invest in the sector.

The other areas that I think can be improved in the program is in the area of privatization. I think the building of the private sector is very critical and, therefore, the privatization must move forward. The 936 program should accommodate lending for purchase of assets.

That is a summary of my presentation and thank you very much.

[The statement of Mr. Ally follows:]

STATEMENT OF

ASGAR ALLY
PRESIDENT
NATIONAL INVESTMENT BANK OF JAMAICA

PRESENTED AT THE

SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

April 3, 1990

Hearings to Review the Use of Funds Held by
Puerto Rican Financial Institutions
Pursuant to Section 936 of the Internal Revenue Code
to Finance Investments in Active Business Assets
and Development Projects in the Caribbean Region

Introduction

I welcome the opportunity to appear before the Committee and to testify at this hearing to review the 936/CBI loan programme.

In my former position of Deputy Governor (International) in the Central Bank of Jamaica and in my current position as President of the National Investment Bank of Jamaica, I have participated in the negotiations for several of the loans granted for investment in Jamaica under the "936" programme. My submission will therefore be based on my experience with the programme. I will also address specific questions on its efficacy and the needs of Jamaica for funding under the programme.

Section 936 Funding in Jamaica

"As it is structured, is the 936/CBI loan programme of substantial benefit to Jamaica?"

To date, six loans totaling over US$82 million were disbursed for investment in Jamaica as follows:

Investor	Sector	Amount (million US$)	Start up
Urban Development Corporation (Gov. of Jamaica)	Housing	7.500	May 1987
South Pacific Textiles (Foreign Investor)	Apparel	1.000	July 1987
Quest (Foreign Investor)	Electronics	0.085	August 1989
Air Jamaica (Gov. of Jamaica)	Transportation (Aircraft Leasing)	51.000	May 1990
Trans Caribbean Cable (Foreign Investor)	Telecommunication	17.000	June 1990
Wyndham Hotel Rosehall (Foreign Investor)	Tourism	6.000	1990
		82.585	

In securing this financing, Jamaica, the first Caribbean Basin country that attempted to gain access to 936 funds, had a difficult time. The necessary regulations were not in place to guide either the lender or the borrower. In spite of the slow start of the programme, however, Jamaica has benefited, especially with the Air Jamaica loan, and we expect to see considerably more funding for viable projects because of the experience both Jamaica and Puerto Rico have gained by working with the programme. In the case of the Air Jamaica financing, although the legal and administrative costs were substantial, 936 funds were the only source of funding available to Air Jamaica to finance the purchase of the air buses. The present structure of the programme does not allow for Jamaica to benefit as much as is possible because Jamaican entities cannot borrow directly from the fund due to the lack of guarantees.

"What needs does Jamaica have that could be satisfied with more of Section 936 Funds?"

The main needs of Jamaica for financing under the 936 Programme are in the following areas:

(1) Tourism - hotels, improved airport facilities, tourist attractions, and tourism related infrastructure

(2) Domestic and Export Agriculture - orchard crops, citrus, dairy

(3) Mining - bauxite and alumina, gypsum, marble, limestone

(4) Low Income Housing

(5) Privatization of government-owned enterprises

(6) Food and fruit processing plants

(7) Shipping, port, and trans-shipment facilities

(8) Electronic information processing

(9) Garment manufacturing for export

(10) Electronic equipment manufacturing for export

There are many profitable investment opportunities in Jamaica but on account of the balance of payments difficulties which the country has been experiencing over the last 15 years, the availability of foreign exchange has been the main constraint to investment by the private sector. Many viable and profitable projects are shelved because of the unavailability of foreign exchange. Under the International Monetary Fund (IMF) stabilization programmes, the country has had to pursue monetary and fiscal policies to reduce the demand for foreign exchange. This has resulted in steep devaluations, tight credit restrictions and very high interest rates of up to 35 percent. Jamaica pays out $200,000,000 more annually to the IMF and the World Bank in debt servicing than we receive.

It is in this context that the 936 funding should play a crucial role in the financing of profitable and viable projects that can earn or save foreign exchange.

The main limitations of the programme and changes recommended are:

(1) Unavailability of loan guarantees: Because of the high level of indebtedness to multilateral and bilateral institutions, and to a lesser extent, to commercial banks, loans to

Jamaica and other CBI countries are regarded as substandard risks by commercial banks. Banks, therefore, will not lend to these countries if the risk of the loan cannot be fully secured. This has been the major obstacle to usage of 936 Funds since commercial banks lend 936 Funds based on the same criteria as any other funds. Therefore, almost all the loans that Jamaica has received have been to U.S. corporations with investments in Jamaica and the loans had to be collateralized by a foreign financial institution as in the case of the Air Jamaica project and the Urban Development Corporation housing project.

(2) No provision for loans for privatization: Jamaica has embarked on a programme to divest its ownership of some state-owned companies: hotels, a portion of the equity in the national airlines, and several other enterprises including land and buildings. The privatization programme forms an integral part of the structural adjustment programme to make the Jamaican economy more market oriented and allow for the greater private sector ownership of the productive sectors of the economy. The privatization programme should be designated as "qualifying investment" of 936 funds.

(3) No provision for financing of purchase of assets by one private sector firm to another private sector firm: Incentives for the investor would be enhanced with the assurance of the existance of a secondary market.

(4) No allowance has been made for the funds to be used for the acquisition of land and real property: According to Jamaican law, no foreigner can purchase land except for development projects, with approval being given by the Bank of Jamaica. The 936 funds should be made available for use by foreign and local investors for the purpose of an approved economic development activity, including the purchase of land. This seems a natural extension to what is already included: provisions for construction, expansion, and upgrading.

(5) Increase five percent limitation on refinancing: Use of 936 funds for refinancing is now limited to five percent of the existing debt. If 936 funds are to be used in business and development projects to stimulate economic development, we need to be able to use these funds to prevent the collapse of existing enterprises by strengthening their financial base. We recommend 100 percent refinancing as a logical step to easing this crippling burden. A compnay now burdened with interest rates of 25 to 30 percent per annum could be automatically changed by refinancing those obligations with 936 funds at 8.5 to 10.5 percent per annum gross.

(6) Guarantor cannot assume the obligation of the borrower: This limitation is of concern to us. A major problem for CBI countries, that of finding guarantors to take the risk on loans, is made even more difficult because of the threat of the immediate call of the loan. The guarantor should have the option to assume the obligation of the borrower, so as to prevent the mandatory call of the debt offering.

(7) "Qualified investments" now limited to loans: The Government of Jamaica recommends that 936 funds be allowed for use in equity investments, particularly through the purchase of debt instruments. Through our debt conversion programme, we hope that by reducing the hard currency cost of purchasing local assets, we will stimulate foreign investment. The amount of convertible debt is approximately 10 percent of our total external debt and we are jealous of how we discount it. In our effort to reduce out external debt burden, we encourage equity investments in Jamaican enterprises, and promote new investments in designated priority areas. These include manufacturing, and services for export, particularly in our free zones, employment generating activities, and the construction or expansion of hotels and factories.

This programme in itself is an attractive one for the foreign investor, and would be made even more so if it could be combined with the low rates of 936 funds.

"What is Jamaica's opinion of the way Puerto Rico has administered the programme?"

In expressing these views, I speak as one who has been personally involved in the effort to implement the Section 936 financing program in Jamaica.

Jamaica reacted to the extension of the Section 936 benefits to the Caribbean with great enthusiasm and optimism. The Government of Jamaica established an office of the Jamaica Promotion Agency (JAMPRO) in San Juan in order to be on the ground floor, so to speak, of the development of the programme. We did not expect or anticipate the complexity of the process in accessing the funds.

There has thus been frustration at the length of time it has taken, the high cost, and the impediments to the implementation of the programme, such as the need for guarantees for the Section 936 loans.

It is my opinion that Puerto Rico has shared our frustration. Antonio Colorado, as Administrator of the Puerto Rico Economic Development Administration, has been a strong advocate of and salesman for the programme. I have no doubt of his full commitment to the success of the programme, and his agency, Fomento, has always been available to provide information and guidance on how to access its benefits. More than this, Mr. Colorado has taken a personal role in pursing the financings which have been accomplished to completion. I believe, however, that he, like us, underestimated the complexity involved in framing the initial loan agreements, the time it would take to obtain regulations to guide the financings from the U.S. Treasury and Internal Revenue Service, and the impediment that is presented by the poor credit position of the eligible Caribbean nations. Thus, all of the deals have been excruciatingly difficult, some of the expected deals have not been consumated, and thoss which have been completed have proven to be more costly than anticipated.

I do not attribute these problems, however, to a failure in the manner in which Puerto Rico has administered the Section 936 investment program. I believe, in fact, that Antonio Colorado has tried very hard to overcome the obstacles to implementation of the programme through pressing for workable regulations, by personal involvement in assisting the completion of financings, and by his constant travels throughout the region to advocate the use of the program. What we need is to address the impediments to the use of Section 936 financing such as the need for guarantees, the extension of the program to include privatization and greater awareness in the region of how to access these funds.

Executive Summary and Recommendations

The financial resources of the 936 programme are perhaps the single most important pool of funds available to Jamaica and other CBI countries for investment in productive enterprises. This is even more so in light of recent developments in Eastern Europe and other areas of the world economy which increase the competition for investment capital.

In Jamaica, the expansion of the domestic private sector is constrained by the unavailability of foreign exchange. Many viable and potentially profitable projects are shelved. In the

meantime, economic growth has slowed down and unemployment and social conditions are worsening. The fragile economic base of Jamaica is under severe stress as nearly 50 percent of the foreign exchange earned by the country are utilized to service external debt. In these circumstances, Jamaica needs access to the Section 936 financing provided by the Tax Reform Act of 1986. The availability of Section 936 financing has been limited, however, because we have not been able to obtain guarantees for certain projects, and because of delays and restrictions in the applicalbe regulations. In view of these circumstances, I suggest that the Oversight Subcommittee consider the following:

1. Development of guarantee mechanism to insure sovereign risk so as to allow local Jamaican entities to borrow from the programme.

2. Development of co-financing arrangements with multilateral lending agencies and bilateral aid agencies.

3. Acceptance of foreign exchage availability letters from Central Bank in view of guarantees as is done by the IFC.

4. Inclusion of privatization and private sector inter-company transactions as eligible for funding.

Chairman PICKLE. I want to thank both of you gentlemen. We had received an acceptance from the Island of Grenada to present testimony, but they called yesterday and canceled. They said they chose to cancel and I am sorry that they did.

I would hope that the various islands and nations throughout that entire area realize that now is the time for them to speak up, if they want loans and if they are having difficulty and they want to participate. If they do not speak out, or are hesitant to, or are even afraid to, then you hurt yourselves.

Mr. Alvarez, I want to thank you, both of you gentlemen. I do have the copies of your statements in front of me. In your statement, you said that the Dominican Republic had really looked forward to a lot of these loans but it had not worked out that way.

You go on to state that "the 936 package is not a very attractive one for Dominican projects. It is Libor minus 0.2 and Dominican investors have to assume exchange risks. Besides, 936 is designed for companies that have collateral within the U.S. territories. That means no small or medium size Dominican projects may qualify," and they have not qualified, I assume. You say Puerto Rico says not many applied, because there is not much point in it, so it is sort of a catch 22.

You say the circle has got to be broken. I hope we can. Why is it so few companies—have you got anything to add to that?

Mr. ALVAREZ. This is in regard to 936 funds, not regarding the twin plants. Regarding the twin plants, the Dominican Republic is the main beneficiary of the cooperation between Puerto Rico and the Caribbean Basin. We do appreciate Puerto Rico's cooperation in that respect.

We are not complaining because of the program, but we would like to have it enhanced. As you may see, the Dominican Republic has benefited from two 936 projects, and it seems to me that if the process is expedited, given the fact that the Dominican Republic just passed a law to privatize the energy service, they will have more projects coming on.

I do not know expedited the process is going to be, but what I know is that a lot of business people in the Dominican Republic and a lot of banks have been complaining because of the process in Puerto Rico. But we are not trying to trash Puerto Rico or anything like that.

We, in fact, support Puerto Rico and encourage Puerto Rico to try to get better things, because otherwise, the Dominican Republic as well as the Caribbean Basin will suffer.

Chairman PICKLE. Well, you indicate that the Dominican businessmen have complained of a slow and cumbersome process pertaining to 936 funds, so you said no company is going to apply for funds if chances are slim that it is going to be approved.

Then you say that most of the companies that have come to the Dominican Republic under the twin plant program have brought their own money or financing, they have not used 936 funds. So, the impact of the 936 in the Dominican Republic has been almost null.

Mr. ALVAREZ. That is correct.

Chairman PICKLE. You are hoping for better, but it is all——

Mr. ALVAREZ. Only our laboratories——

Chairman PICKLE. We are going to submit to you a list of questions that we hope you would answer to us more specifically, aside from your testimony. We want to know if the 936/CBI program is of substantial benefit to your country as it is currently structured, what needs does your country have that could be satisfied if more loans under 936 were available, what are the limitations—and you both mentioned some limitations in your testimony—what is your opinion of the way Puerto Rico has administered the 936/CBI loan program and what changes could be made in these programs.

I know specifically you made suggestions in your outline, Mr. Alvarez, and I did not understand all of your testimony, Mr. Ally, but I hope you did.

I will say to you and to all of the nations down through the islands, if you do want to participate, at least this is a source of funds and you should speak out and you should let us know when you are applying. We would like to just review it as you move along, so we will be knowledgeable of what you are asking for.

Mr. ALVAREZ. What the Dominican Republican would like to see, the Dominican Republic would like to see within 936 specialized funds that cannot raise the needs of small- and medium-sized business and Dominican projects as well.

Mr. ALLY. I would support that, because the way the program operates now, you are faced with a constraint of the sovereign risk and the banks are not putting up any new money, therefore, from day 1 it is no use going to the 936 funds, because the needs are there but the financing cannot be obtained, because, of the country risk, you cannot quality for the loans.

Chairman PICKLE. Because of the what?

Mr. ALLY. Because of the country risk. In other words, the way the commercial banks who are making the loans operate, unless the loans are guaranteed by a AAA bank or a AA bank, you are not allowed to use the resources.

Mr. RANGEL. Mr. Chairman.

Chairman PICKLE. I have completed my questions.

Mr. SCHULZE. I would be happy to yield to the gentleman from New York.

Mr. RANGEL. I appreciate this, because I think these two witnesses are getting to the core of the problem that this committee is facing and that they have an obstacle to overcome. That is, the 936 funds that are in the banks are being subjected to the same banking regulations as any other bank would ask for before they commit themselves to the loans.

The benefit, of course, is a lower interest rate. Now, in these countries, Mr. Anthony, you and I would like to see the smaller companies participate and receive the loans. However, the banks are looking at how much the companies owe, the political and economic risk that is involved, and they are making banking decisions.

Now, if somewhere along the line we are able to guarantee the 936 funds the loans that are being made that both of these gentlemen are requesting——

Chairman PICKLE. When you say we, are you talking of the United States or Puerto Rico?

Mr. RANGEL. Well, the Puerto Rican banks have an obligation, a fiduciary relationship with the depositors. They cannot guarantee the loans. It would seem to me that if we want to make certain that these banks get the money out to the people that we want, that we are going to have to do something to guarantee those loans.

Mr. SCHULZE. I thank the gentleman for his contribution.

Let me say that if we are going to do that, I would like to get that for the banks of Pennsylvania and we will be happy to lend the money on a guaranteed basis, we would love to. Our banks would be overjoyed to do it on a guaranteed basis. If you give the banks of the Commonwealth of Pennsylvania $12 billion, we will put out $1 billion at 3 percent interest.

Mr. RANGEL. The loans are not——

Mr. SCHULZE. We would be happy to do it.

Mr. RANGEL. The loans are not going to happen, if we are asking developing countries and small businesses, and if we are asking the Puerto Rican banks to do the right thing and to loan the money, without having assurances that money can be paid back. Then I think that the standard is too high for us to really believe that the banks are not going to make prudent decisions that would cause them to have those funds released.

Mr. SCHULZE. Charlie, I really agree with you partially, but it seems to me that is why we are giving them section 936. These institutions should be willing to take some—I do not say put it all into high-risk areas, but they darned sure ought to be able to have some risk involved in those loans. That is what banking involves. There is a lot of difference between bankers and clerks today, but we need some more bankers.

Mr. Chairman, I thank you for yielding.

I would like to congratulate our two witnesses. They have both been positive and they have given concrete solutions and suggestions.

Mr. Alvarez, if a small- or medium-size manufacturer in your country today wants to expand his plant or double his capacity, tell me where he gets the money, how does he do it today?

Mr. ALVAREZ. Well, due to government regulation, it is very difficult to get money in the formal markets. They have to go to the informal markets, to a financial institution that is charging more than 40 percent a year just to get the money. Financing in the Dominican Republic is not an easy task and it seems to me that if you do not get a foreign partner to finance your venture, you are almost unable to get financing, because of financial constraints.

Right now, we are in a situation in which we cannot provide cheap financing, because if we expand our monetary base, inflation will cripple the income of people. So, right now, we have real constraints with central bank financing and we have not been able to reach agreement with the IMF or the World Bank to get external financing, and AID has not given aid to the Dominican Republic, so we have big problems.

Mr. SCHULZE. So, if I am a small- or medium-size manufacturer, in order to expand my business, the odds are that I would go to perhaps the United States and look for a partner and then go to

Miami and use Miami as a source of funds. Is that an accurate portrayal?

Mr. ALVAREZ. It is more likely that they will go to New York and look for some Dominican partner or Miami, maybe some people that make money outside the legal framework, but they will get the money. Somewhere they will get the money, maybe the interest rate is going to be really high, but they will get the money.

Mr. SCHULZE. The interest rates are as high as 40 percent, you said?

Mr. ALVAREZ. More than 40 percent, for sure; 20 percent is something that you do not even get in the formal market; 22 percent is the exchange that the central bank has set.

Mr. SCHULZE. How about local banks?

Mr. ALVAREZ. We have a crunch in the financial sector. As I told you, when we signed tax information exchange agreement, we assume that some of the money, because it was not clear, left the country, so a lot of banks are having cash problems. We have had two bank runs. One of these banks is still closed. So, to get financing in the Dominican Republic is a real problem at this moment.

Mr. SCHULZE. I thank you, Mr. Alvarez, and I thank you, Mr. Ally, for your testimony.

Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Rangel.

Mr. RANGEL. I would like Mr. Alvarez to find out why there would be a flight of capital from the Dominican banks as a result of the signing of the tax exchange treaty. Where would that money go?

Mr. ALVAREZ. Maybe to Grand Cayman. It seems to me that——

Mr. RANGEL. It seems to me that you get information as to what Dominican money is in U.S. banks as a result of that treaty.

Mr. ALVAREZ. I am not sure I quite understood that question.

Mr. RANGEL. How would the signing of the treaty with the United States of America cause Dominican depositors to take their money out of Dominican banks?

Mr. ALVAREZ. Maybe some people that have money that has not been declared took their money out of the country. I do not know. Not even the U.S. authorities have been able to say what happened, why this money went out of the country.

Mr. RANGEL. Are you talking about Americans withdrawing out of American banks?

Mr. ALVAREZ. Americans and Dominicans, as well. Most of them are Dominicans, but they have businesses and investments in the United States. It seems to me that it is not easy for the Dominican Government, it has not been easy for the authorities that are in the Dominican Republic to supervise the banking system, due to the agreement that we signed with the United States. It is a question that I cannot answer precisely, but we assume that it is because of that fact.

Mr. RANGEL. Let me see if I understand what you are saying. You are saying that U.S. depositors——

Mr. ALVAREZ. Deposits in Dominican banks, they may belong to Dominicans, they may belong to Americans, they may belong to Canadians, they may belong to Italians—they are gone, they have

left the country. We suspect that one of the reasons is because of the signing of the tax exchange information agreement.

Mr. RANGEL. Well, are not both of your countries depending on more from the United States than just the 936 funds? I mean it seems as though this committee believes that the success of the Caribbean Basin Initiative is based on bank loans emanating from money in Puerto Rico.

Mr. ALLY. If I may answer that, I think the 936 program is not a panacea for the problems of countries like Jamaica. It is one source. But in the hard realities of the world today, it is the only major source of finance that countries like Jamaica can tap for investment.

Mr. RANGEL. But are you not saying that banks are pretty hard on Jamaica, because of your economic situation?

Mr. ALLY. They are.

Mr. RANGEL. And is not the Puerto Rican 936 funds another bank?

Mr. ALLY. Yes, but you have $15 billion in Puerto Rico. Now, that $15 billion, to the extent that programs can be designed for these countries to tap into those resources, then economic development and progress in the regions will move forward.

Mr. RANGEL. Well, that is what——

Mr. ALLY. But if that depends on the banks outside of the 936 program, the answer is no, they are going not be a net transfer of resources. The commercial banks are doing it, the IMF is doing it, the World Bank is doing it. There is a net transfer of resources from the Caribbean of over $300 or $400 million a year. In my country alone, there is a net transfer of $200 million. Now, what that means to the private sector in these countries it that where you are spending 50 percent of your earnings to pay debt, private sector companies are contracting and, therefore, because the availability of foreign exchange is just not there. These are open economies and we have to trade to live.

Mr. RANGEL. Well, the chairman——

Mr. ALLY. You have to have investment. The way the world economy works today, countries like Jamaica will find it more and more difficult to expand the private sector, yet the American Congress, the World Bank and the IMF, quite rightly so, and the government of Jamaica is asking us to make the economy more and more market-oriented. The private sector is prepared to take up the challenge, but they want the tools to do so.

The funding is not like in the old days, where you could go to a bank in New York, any private sector company could go and borrow. They cannot borrow today, as my colleague from the Dominican Republic said. They are faced with 40-percent interest in my country, plus there is a limited amount of loans that are available, because of the fact that you have to contract the economy to pay the debt. You are, in fact paying the debts by contracting the economy and reducing the jobs of workers.

Mr. SCHULZE. Would the gentleman from New York yield for just one question?

Mr. RANGEL. I yield.

Mr. SCHULZE. Would you gentlemen give me your opinion of how much money could be absorbed and utilized well—I do not mean

just throwing money—how much in the Caribbean, how much money could it take? Could $1 billion or $2 billion or $3 billion be absorbed and utilized well? I do not mean——

Mr. ALLY. I would say, in my view, in the Caribbean, the CBI countries, for loanable funds to expand the productive capacity of these countries, it would require at least $2 billion a year, at least $2 billion a year, at minimum, and the United States, in fact, would be a major beneficiary of that expansion, because trade will expand.

What is happening today? We have to cut our imports from the United States, because there is no ability to pay for these imports.

Mr. SCHULZE. I thank the gentleman for yielding.

Mr. RANGEL. I think the chairman and certainly Mr. Schulze and I want as many recommendations, especially from the private sector, as to what we can do to make certain that these funds are available.

Now, you mentioned guarantee. When I mentioned guarantee, Mr. Schulze laughed, but obviously the answer must be some place in between. You do not expect the banks in Puerto Rico to take risks that Jamaican banks will not take, so we have to perhaps—guarantee is a strong word, but if we are going to hold the Puerto Rican bankers to the same standards as any other bankers, then we are going to have to do something in order to make certain that the people we want to have access to the funds would have access.

I want to thank the chairman for pointing the committee in that direction.

Chairman PICKLE. I thank you.

Let me ask both of you once more, what is the hesitancy of businessmen, American businesses in your country to encourage the tax treaty? What are they afraid of?

Mr. ALLY. In my country, sir, we have a tax treaty with the United States. We have a double-taxation treaty, we have signed the——

Chairman PICKLE. Well, both of you, you——

Mr. ALLY. The people are afraid of the tax treaty, I would say because of the information. Places like Grand Cayman are tax havens and, therefore, the deposits in these countries are done also for tax purposes.

Chairman PICKLE. They are afraid of the information that will be known?

Mr. ALLY. Yes, sir.

Chairman PICKLE. What information?

Mr. ALLY. Information on how much income they are getting from these investments will flow back to the authorities in the countries like Jamaica and that will be used to track the funds down and to be able to assess their income at a higher levels.

Chairman PICKLE. Mr. Alvarez, what are they afraid of?

Mr. ALVAREZ. I may add that there may be some dirty money, as well, besides that. Some people are really afraid of that, but it does not seem to me that it is easy to prove, because——

Chairman PICKLE. It has to be information about investments?

Mr. ALLY. Investments, yes.

Chairman PICKLE. Income of all sources?

Mr. ALLY. Yes. It seems to me that it is easier to be out in Grand Cayman, their funds are not going to be touched or the amount of their resources are not going to be disclosed. But in the Dominican Republic, it is a country in which the American authorities are supervising the banking system.

Chairman PICKLE. Well, I do not want to dwell on that point, but I think that is important and we will be trying to pursue that aspect further.

Well, we have got two other panels and I am going to move on. I want to thank you both for your testimony and thank you for coming. Now, let me say again, of all the nations we have got down there, we only got two to accept to come to testify. I do not know whether that is an indication that they are hesitant to do it. I can understand why we would not have somebody here who did not have a treaty, but we will have other hearings and I am hoping if other nations want to appear or submit testimony, they will do so.

I thank both of you gentlemen very much. Thank you.

Chairman PICKLE. Now the next panel will be Mr. Terry Wadsworth, Mr. Carlos Ubiñas, and Mr. Carlos Burns.

If you three gentlemen would come forward?

Now, Mr. Terry Wadsworth, on my right, is the vice president of the Chase Manhattan Bank; and Mr. Carlos Ubiñas is the vice president of Paine Webber of Puerto Rico; and Mr. Carlos Burns, the vice president of the BT Securities Corp., Puerto Rico branch.

Mr. Wadsworth, if you will present your testimony first and I am going to ask you all in the interest of time to summarize your statements. We have your statements so that they will all be included in the record in their entirety.

Mr. Wadsworth.

STATEMENT OF TERRENCE WADSWORTH, SENIOR VICE PRESIDENT AND GENERAL MANAGER, CHASE MANHATTAN BANK, N.A., PUERTO RICO

Mr. WADSWORTH. Mr. Chairman and members of the committee, I am Terrence Wadsworth, senior vice president and general manager of the Chase Manhattan Bank's Puerto Rico operations.

It is an honor to be with you today describing Chase's involvement in the Caribbean Basin Initiative, and to discuss how the program might be refined to increase financial institutions' participation in section 936 loans to Caribbean Basin firms.

I am pleased to tell you that our support for the CBI dates from its inception in 1981. Since 1986, we have been actively working with the government of Puerto Rico to encourage 936 company investments and the use of 936 funds.

As you have asked that this oral testimony to be limited to 5 minutes, I will summarize what I have submitted in writing.

First, Chase's loans for CBI/936 projects total more than $40 million. Our most far reaching participation was financing the construction and installation of the Jamaican segment of the fiber optic telecommunications cable extending from Florida to Puerto Rico through the Caribbean and into South America.

Another Chase 936 loan was used to acquire and install a power generation barge for producing electrical power in the Dominican

Republic. Our third loan was used to enhance tourism in Jamaica through the renovation of a resort purchased from the government.

At the moment, Chase Puerto Rico is analyzing a dozen new 936 proposals totalling over $100 million, in areas from manufacturing to oil exploration and to hotel construction. As beneficial to the economic development of the Caribbean Basin as the 936 program is, we believe modifications in certain areas would improve it.

But first, I think it important to point out that there are some significant structural impediments to a more rapid expansion of bank lending in these countries. These small economies are, unfortunately caught up in the LDC debt problem. Several have been forced to reschedule their obligations which now trade at deep discounts in the secondary market. In that environment the number of commercially bankable enterprises is small. The basic role of commercial banks traditionally has been to accept their customer's deposits and prudently lend or invest them. Funds committed to 936 loans are no exception.

It is difficult for any commercial bank to take anything resembling an aggressive posture when it comes to new extensions of credit in the region. Rather, an important source of developmental capital and guarantees must be the international agencies and official lending sources, such as USAID, OPIC, the Inter-American Development Bank, the World Bank and others. It is these development agencies, rather than commercial banks, which should be in the forefront of financing much needed infrastructure development.

Given this fact, it is unfortunate that our own regulatory environment has added additional and, I think often unnecessary roadblocks. Let me briefly touch on several of these and suggest refinements that you might consider.

A primary detriment to making 936 loans is the Treasury Department's rule that we may not finance projects in countries that have not signed tax information exchange agreements. This limits lending to only 6 of the 22 CBI eligible countries.

A series of frustrating regulations limits the class of activities eligible for financing. The financing of privatization is excluded. And yet, that represents a promising area of investment. The hotel renovation project in Jamaica that I mentioned would have benefited further if Chase had also been permitted to commit 936 funds for its acquisition. It was especially frustrating since the project was guaranteed by OPIC.

Also considered ineligible for 936 funds are the purchase of land—property already being used in the country and working capital not directly related to the investment in plant and equipment. Business expansion often depends upon such financing.

Nor are we permitted to lend 936 funds to a borrower who wishes to make an equity investment in an entity that would, in turn, purchase qualified assets. This restriction tends to frustrate local ownership in viable Caribbean businesses.

In a general sense, the overall objective of the 936/CBI program to promote economic development is irrefferable. What is needed now is greater participation by the international guarantee and development agencies and refinements in the regulatory strictures that inhibit achievement of that goal. It is for these reasons that

we, who are concerned with the continued economic development of our Caribbean neighbors applaud this committee for its interest in the CBI and the 936 program.

We also commend the government of Puerto Rico for its considerable efforts to promote the CBI and for its many accomplishments to date.

Thank you, very much, Mr. Chairman.

[The statement of Mr. Wadsworth follows:]

STATEMENT OF TERRENCE WADSWORTH
ON BEHALF OF THE CHASE MANHATTAN BANK, N.A.

April 3, 1990

Good morning. I am Terrence Wadsworth, Senior Vice President and General Manager for the Chase Manhattan Bank in Puerto Rico. I am pleased to be here this morning before the Subcommittee on Oversight of the Committee on Ways and Means to describe Chase's involvement in § 936 loans to companies in Caribbean Basin countries and to discuss with you ways for increasing financial institution participation in that worthy program.

The Chase Manhattan Bank, N.A. is an active lender in the Caribbean and, through our branch in Puerto Rico, a participating lender in the Caribbean Basin Initiative (CBI). Together with the government of Puerto Rico, Chase has worked very hard to promote new investment in the Caribbean Basin. Since the inception of the CBI, Chase Puerto Rico has reviewed over 20 proposals to lend § 936 funds for use in the Caribbean Basin. However, for a variety of economic reasons and a number of programmatic flaws which are addressed below, we have funded only three of these.

Let me first describe our three completed § 936 projects, which total over $40 million. An $18 million Chase loan allowed the Seaboard Corporation Group to acquire and install a power generation barge which will produce 40 megawatts of electrical power which the Group can then sell to the state power authority in the Dominican Republic. Our second loan, made to the Rose Hall Associates Limited Partnership, was the first CBI loan to be guaranteed by the Overseas Private Investment Corporation (OPIC). Of the over $10 million needed by this company to renovate a resort which it had purchased from the Jamaican government, Chase provided $6 million in CBI funds. Perhaps the most far-reaching project Chase helped finance was a $180 million undertaking in which AT&T built and installed a fiber optic telecommunications cable extending from Florida to Puerto Rico and throughout the Caribbean and parts of South America. The U.S. Treasury ruled that only $17 million, corresponding to the Jamaica segment of the project, was eligible for CBI financing because Jamaica was the only one of the participating countries that had a tax information exchange agreement in place with the United States at that time. Chase funded the entire amount eligible for § 936 funds. All of the loans we have made are medium term loans with maturities ranging from five to ten years. Two have floating interest rates and the other is at a fixed rate. Two are guaranteed by the parent company and the third is guaranteed by OPIC.

Chase Puerto Rico is now considering ten other proposals which total over $100 million and include manufacturing, oil exploration and hotel and warehouse construction. When analyzing projects for § 936 funding in the Caribbean, Chase Puerto Rico applies its standard credit analysis. A project must be economically viable and its sponsors must have sufficient capital and experience. Unfortunately, there is a dearth of such projects in the eligible countries. Many of the proposals we receive are for businesses that are either too risky or thinly capitalized, a circumstance that is not atypical of small businesses everywhere. Unlike the situation in the United States and other developed countries, these businesses do not have the benefit of working in a more fully developed business economy with access to the capital markets. Some proposals show only limited possibilities of success and others, because they lack sufficient equity capital, would overburden the borrower with debt. In many cases, project sponsors are unable to enhance the credit to acceptable risk levels.

Even for projects that might otherwise be creditworthy, or can be locally enhanced, banks still face risks attributable to the country in which the business will operate. Underlying every credit decision for Chase, and all other financial institutions, has been the economic climate of the region generally. Caribbean Basin countries essentially are less developed countries with all the attendant problems of larger LDC debtors. The current debt situation has been a particularly negative inhibitor in our ability and willingness to make loans in countries which have had difficulty in meeting their debt burden. Because CBI countries generally are more dependent than others on international economic conditions, because of their reliance on tourism and a few key commodities, they were especially vulnerable to the past decade's downturns in the world economy. During that period, per capita income declined in many Caribbean Basin countries and it is difficult to argue today that most CBI countries exhibit the vigorous growth needed to justify the extension of new, unsupported credits. Individual country risk arising from economic, political and social conditions that may affect a private borrower's ability to repay is critical to our credit decisions. For the most part, the economies of CBI countries have been beset by difficult conditions related to their foreign exchange earnings and their resultant inability to service their debt. Of the six countries eligible for CBI credits, their real Gross Domestic Product (GDP) growth last year was only 1%, and their per capita income declined as well. Using conventional debt capacity measures, their average debt service ratio was 25%, the debt to GDP ratio was 90% and their external debt was 1 1/2 times greater than their export of goods and services. Such figures do not suggest good crediworthiness for commercial bank lending.

The problems and losses this situation has created for U.S. banks is well known to this committee. Insurance and guarantees made by U.S. and international agencies mitigate such country and currency risk in many less developed countries, but unfortunately have not been readily available for projects eligible for CBI funds. One notable exception is the guarantee provided by OPIC to the Rose Hall hotel acquisition and renovation. However, in spite of the guarantee, Treasury regulations permitted us to provide CBI funds only for the renovation, but not the purchase, since privatization and fixed asset acquisition surprisingly are not eligible activities.

Were all these obstacles to disappear tomorrow, however, restrictions in the U.S. Treasury Department's regulations on qualified investments would still limit our ability to provide CBI financing. Many proposals never make it beyond the preliminary application stage because they do not comply with Treasury's threshold requirements. The first significant obstacle must be overcome even before the application process begins. We may lend only for projects in countries that have signed tax information exchange agreements. Until recently, only four countries qualified. Today, six countries have agreements in place, but there are twenty-two CBI eligible countries.

There are also a series of very frustrating regulatory restrictions and limitations on which assets are eligible for financing. For example, the financing of privatization is not considered an eligible activity, although it must be considered a high priority of United States policy. Also excluded are land; the acquisition of real property, such as buildings; property already being used in the country; and working capital not related to other investment in plant and equipment. Even when related to other investment, working capital is unrealistically limited to only 10% of the project cost. These limitations are especially severe since working capital, such

as money needed for the purchase of inventory or the financing of accounts receivable, is often a critical element affecting the success or failure of smaller businesses. We are also not permitted to lend § 936 funds to a borrower who wishes to make an equity investment in an entity which would then purchase qualified assets.

Even more impediments to the CBI lending process are written into the regulations adopted by the U.S. Treasury. Like regulations adopted in Puerto Rico, Treasury requires that Puerto Rico's Commissioner of Financial Institutions specifically approve every CBI project. This has meant obtaining a legal opinion on all projects, even straightforward bank loans, a cost that small projects can ill afford. By contrast, loans for projects in Puerto Rico do not require such approval, but rely on standard fiduciary and "due diligence" measures that should suffice for CBI loans. From our experience, it appears as though many of the regulatory strictures were drafted with such an over abundance of concern for potential misuses of § 936 funds that they instead constrain effective use of the funds for worthy economic development initiatives. Uncertainty over the permanence of the § 936 program also inhibits long-term investment in the Caribbean Basin.

We strongly believe that financing infrastructure projects, which by their very nature depend upon extended pay-back periods, whether with § 936 or other funds, is not within the realm of commercial bank lending. Although the regulations permit us to commit such funds to infrastructure projects, they are particularly plagued by the foreign exchange and country risk problems I have just described. Financing infrastructure projects falls more appropriately within the purview of international lending agencies.

Legislative or regulatory changes that would liberalize the inhibiting effects of the Treasury's Temporary Regulations I have just discussed would make § 936 funds more accessible. A simplified approval process would make it more economical for banks to make loans to fund smaller projects. Allowing qualified financial institutions to rely on local banks to share the task of monitoring compliance with the regulatory requirements on the use of funds would encourage local institutions to originate loans and accept some of the credit risk. Many Caribbean Basin projects cannot provide sufficient guarantees, while others, which are backed by OPIC or other sponsorship or guarantee agencies, do not conform to CBI regulatory requirements. Viable projects with endorsements from recognized agencies should be made eligible for CBI § 936 funding. At the same time, government and international lending and guarantee agencies should be urged to take a more active part in supporting projects that do qualify for funding. Expanding government insurance programs to cover political and currency risk would also mean that local loans could then be funded with § 936 money.

Thank you for this opportunity to present our comments on the state of the CBI § 936 loan program and to suggest ways in which the program can be improved and expanded. We commend the government of Puerto Rico for its considerable efforts to promote the CBI and for the many accomplishments realized to date. The Chase Manhattan Bank looks forward to continuing to be a significant lender to the Caribbean Basin and to playing a major role in facilitating the effective use of § 936 funds for economic development in the region.

Chairman PICKLE. Thank you, Mr. Wadsworth.
And now, Mr. Ubiñas.

STATEMENT OF CARLOS UBIÑAS, EXECUTIVE VICE PRESIDENT, PAINE WEBBER, INC., PUERTO RICO

Mr. UBIÑAS. Mr. Chairman and members of the subcommittee, it is an honor for me to have been invited to appear before you to address the topic of the use of section 936 funds in the Caribbean Basin region.

Again, my name is Carlos Ubiñas, and I am the executive vice president of Paine Webber, Inc., of Puerto Rico and prior to joining Paine Webber in June of 1989, I was senior executive vice president of the Government Development Bank for Puerto Rico from 1986 to 1989.

In that capacity I was directly responsible for all capital markets and direct lending activities of the bank and was therefore, closely involved with the use of section 936 funds for the CBI.

The invitation to address this subcommittee sets forth a number of questions for me to respond. Although it is impossible to cover such a complex and broad topic in the allotted time, I will do my best to be comprehensive and short.

The presentation is divided into two parts; a broad overview of the section 936 funds market and specific responses to the questions set forth in the letter of invitation dated March 23.

About the section 936 funds market. First, I think it is important to define what section 936 funds are and as has been stated before, they are the retained earnings of section 936 companies. In terms of the statutory and regulatory framework that governs the investment of these funds, under both U.S. and Puerto Rico laws, the earnings from the investment of these funds are entitled to certain tax benefits if invested in specified activities in Puerto Rico and more recently, in eligible Caribbean countries.

In the case of Puerto Rico these funds can be invested directly by the companies in the eligible activities or indirectly through financial intermediaries. In the case of the Caribbean, the funds can only be channeled indirectly through financial intermediaries. I should note, however, that Puerto Rico has recently approved legislation authorizing the creation of an investment vehicle that will allow CBI borrowers direct access to section 936 funds.

Regulation 3582 of the Office of the Commissioner of Financial Institutions governs the receipt and on lending activities involving section 936 funds held by financial institutions.

The key requirement is that 100 percent of the funds must be invested in the specified activities 100 percent of the time, therefore, there are no idle funds in the system.

In fact, the regulations sometimes require that financial institutions invest more than $1 for each 936 dollar received.

In terms of market characteristics historically 936 rates have averaged between 75 to 85 percent of LIBOR. The rates are influenced by supply and demand factors, changes in U.S. and Puerto Rico tax laws and regulations, cash needs of the companies in the U.S. and worldwide interest rates.

These rates are rates that bank and other intermediaries pay 936 companies on their deposits. The rates charged on loans are somewhat higher to reflect regulatory and other costs plus a spread to the financial intermediary.

The terms of these loans range anywhere from 7 days to 10 years typically.

In terms of credit, this is the key issue in the 936 market. The credit issue is twofold. In the first instance, 936 companies are very conservative and credit quality conscious reflecting the parent company investment policies and guidelines. Typically a 936 company will not invest in an instrument that does not have a direct or implied credit rating of A or better.

The financial intermediary must therefore be prudent in its own lending activities or risk not having the assets to repay its obligations to the 936 depositor. If I may be bold, a good illustration of the risk associated with imprudent behavior lending behavior is the S&L crisis.

Very few borrowers in Puerto Rico meet those credit requirements. Over the last 15 years, however, Puerto Rico borrowers have sought to overcome this obstacle through the use of letters of credit. The market has developed to the point where most capital market transactions are done with letters of credit and issued by resident as well as nonresident national and foreign financial institutions.

The credit requirements for CBI borrowers are identical. Loans to the CBI, however, have the additional challenges of political risk or country risk and foreign exchange risks.

In terms of demand, it is important that a discussion of the 936 market would not be complete without a brief mention of the issue of demand for the funds.

The 936 funds are only a source of funds. These funds will not, in and of themselves, create demand for the funds. Thus, there must be effective demand in the countries for the funds independently of their availability. I should note that it has taken Puerto Rico close to 40 years to achieve its present status of the most economically developed of the Caribbean islands. This is a direct result of the successful implementation of economic development and fiscal policies designed to attract direct investment to Puerto Rico. These investments and the resulting economic activity created demand for the funds as a source of capital to finance the economic activity.

Likewise, it seems to me, that a key challenge to the successful use of section 936 funds is the development of sound economic and fiscal policies in our neighboring islands that will, in turn create incentives, not barriers, to investment that will lead to additional demand for section 936 funds.

Finally, if I may respond to the specific questions addressed by the committee. The questions one, two and three were: with what projects funded with section 936 funds have you been involved? What were the terms of the loans and what are the nature of the projects?

During my time at Government Development Bank, I was involved fundamentally with three major projects, the first being the Jamaican housing loan which has been discussed extensively today. And I was initially involved with the initial discussions regarding

the Air Jamaica loan and with a project that we refer to as Tru-Citrus, which was the funding of a company in Puerto Rico that would produce fresh orange juice and the raw material for the company would be purchased from Jamaica.

Your fourth question is, are you aware of applications for loans of section 936 funds that were not approved?

I think I can remember two important cases. Spanish Fort, which was the development of a manufacturing free-zone in Jamaica. And the loan was not approved by the Government Development Bank because at the time that it was made, the credit was not acceptable to the bank. The reason that the credit was not acceptable to the bank at that time, was that fundamentally the developer had not yet leased out the spaces in the free-trade zone and the credit of the developer was not acceptable.

The other project involved a project that involved the use of a bilateral agency or a multilateral agency called the Central American Bank for Economic Integration.

And the idea there was that GDB would extend credit to this Central American bank who would then extend credit to projects in the various member countries. That structure was deemed ideal because the credit risk of that financial intermediary or multilateral bank was an acceptable credit risk for the Government Development Bank, a risk that we knew well and we felt that it was efficient to do it that way because that financial intermediary, in turn, knew very well the credit risk of the particular countries that were a member of this bank. So we felt that we fulfilled a lot of the credit issues and other requirements in order to effectively make these loans.

And unfortunately the loan request was turned down by the Internal Revenue Service, or the Treasury.

Question No. 5 is what criteria have been applied in considering applications for loans for section 936 funds? In terms of credit requirements the criteria are exactly the same as apply in Puerto Rico and I have discussed them previously. You know, as I mentioned also in the case of section 936 funds, there is the additional complication of country risk and foreign exchange risk.

Question 7 is, what is the potential for the use of commercial loans of section 936 funds to finance infrastructure projects in the CBI? I am sorry, question 6 is, what impediments are there to use of section 936 funds for loans in eligible CBI countries?

I think I would highlight three sets of impediments. The first is effective demand. These countries have a number of barriers that act as—a number of policies and fiscal policies and economic development policies which effectively act as barriers to direct investment which affect the demand for the use of section 936 funds.

I would also highlight legal and regulatory issues in this regard the proposed, it seems to me that the proposed Treasury regulations are too restrictive. We should recognize that the CBI involves many distinct and underdeveloped markets and it is frankly unrealistic to pretend to regulate these markets in the same fashion that we regulate the U.S. financial market, which is probably the most efficient financial market in the world.

I think we should also be more flexible in the use of financial structures and vehicles to ensure that the maximum amount of sec-

tion 936 funds are channeled to these islands. And the issue of privatization, which has been discussed previously and finally, multiple intermediation.

In terms of intermediation, I mean we must recognize that the more intermediaries we have in the chain the higher the cost of the financing. However, on the other hand, you have got financial institutions, for example, in Puerto Rico that may not have a presence in say, Grenada. And it is very difficult to get a financial institution that does not have a physical presence in a particular country to take a risk in that particular country. So that you can, through intermediation solve that barrier. For example, the loan can be made to a financial institution in Puerto Rico who can then make a loan to a multilateral institution, for example, as was the case in the Central American Bank for Economic Integration and that bank, in turn, can make a subsequent loan to a financial institution in one of the member countries who knows the credit risk associated with that particular country very well. And will be willing to take the ultimate credit risk in that eligible borrower.

And it seems to me that although we do raise the cost, the ultimate cost of the funds through these type of mechanisms, we achieve the goal of getting the funds to the country which is, in and of itself, a very difficult thing these days.

And finally, the other impediment to the use of funds obviously is the issue of credit risk, political risk and foreign exchange risk. In terms of the credit risk, I can say that is the same issue that Puerto Rican borrowers are faced with for the last 40 years. Puerto Rico 40 years ago was no different than what Jamaica is today or the Dominican Republic is today. And we have, I think, through a lot of creativity been able to develop the mechanisms to overcome those credit risks.

In terms of political risks and foreign exchange risks, I think here, you know, it seems to me the only way to solve these issues is through the effective use of U.S. Government agencies bilateral agencies, and multilateral agencies that cover these types of risks.

Question No. 7 is, what is the potential for the use of commercial loans in the area of infrastructure? These are very complex and risky loans, particularly because for the most part, they involve lending to the countries, themselves. Most of the utilities, for example, are government-owned so that in addition to having the normal credit risk, you have got the country risk associated with lending directly to a government.

So in terms of complexity, I mean I would sort of categorize them in various respects. First of all, who is the borrower? And if the borrower is a public entity, it is going to be much more complex and much more a riskier loan than if that borrower were a private entity. For example, in those countries where a particular utility, for example, may have been privatized.

Also the type of infrastructure project is important and maybe we can categorize them in two broad categories. The first are those that generate foreign exchange as would be the case with the national airlines, for example, to the extent that you may consider a national airline as an infrastructure project. Or port facilities, where in many cases the countries will charge rates that are based on dollars.

And the other, obviously, are those infrastructure projects that do not generate foreign exchange as would be the utilities, road projects and the like. Obviously those would be much more complex and riskier.

And finally, the other key element in any infrastructure projects is the availability of financial assistance from multilateral agencies as would be the case with the IFC, for example.

Finally, what changes could be made in the section 936 funds loan program to encourage more investment and development in the CBI region?

I would highlight four elements. First I think it is key to stimulate demand by helping to create incentives to investments in these countries as opposed to barriers to investment. And that has to do with, you know, from making sure that U.S. legislation, such as the CBI legislation, itself, acts as a promoter of investment and not as a barrier to investment. As well as dealing with the particular fiscal and economic development policies of the nations, themselves, which many times act as absolute barriers to investment.

For example, the imposition of a 25 percent tax on the importation of capital goods. It is very difficult to make business in these countries if you have fiscal policies such as that.

Second, I think more flexibility in the regulatory framework as we have discussed. We should also encourage broader participation by U.S., bilateral and multilateral agencies.

And finally, I think we should be realistic and I think the goal here should be that all 936 eligible projects that meet the eligibility criteria set forth in the 936 statute, itself, as well as the credit requirements of the 936 market actually get funded with 936 funds.

I think if we achieve 90 percent of that, the program would have been a great success.

Thank you.

Mr. RANGEL [presiding]. Mr. Burns, you are welcome to give us your statement.

STATEMENT OF CARLOS A. BURNS, VICE PRESIDENT, BT SECURITIES CORP., PUERTO RICO BRANCH, SAN JUAN, PUERTO RICO

Mr. BURNS. Good afternoon, Mr. Chairman and members of the committee. My name is Carlos Burns and I am currently employed by BT Securities Corp. which is a subsidiary of Bankers Trust, New York Corp.

The recently organized Puerto Rico branch of BT Securities is engaged in the merchant investment banking business in the Caribbean Basin. Prior to joining BT Securities in December of 1989, I was with another investment bank in Puerto Rico where over the last 3 years I devoted nearly 100 percent of my time to developing section 936 financings in the Caribbean.

Candidly the first 3 years after the enactment of section 936(d)(4) in October of 1986, up until the issuance of the temporary regulations in September of 1989, were exceedingly frustrating.

During that period, I was involved with projects requiring more than $170 million of section 936 funds. And two were turned down by various government authorities and one closed in August of 1989 and the fourth is closing within the next 2 weeks.

I would like to summarize these four transactions to highlight some of the difficulties of the program as well as successes.

The first project I worked on was the Spanish Fort free-zone. At the request of the Jamaican government back in 1987, I agreed to arrange on a best efforts basis $13 million in section 936 financing for a 726,000 square foot free-zone to be known as the Spanish Fort free-zone.

The free-zone would have provided more than 15,000 jobs in the high unemployment area of Spanish Town, provided valuable hard currency for the Jamaican government, and most importantly, would have provided adequate facilities for foreign manufacturers to set up shop.

Approvals for the transaction were promptly obtained, however the guarantees sought from various agencies which were required were never approved for policy or lending limitation reasons.

The second transaction involved the refinancing of approximately $90 million of financed leases for Air Jamaica, the national carrier of Jamaica. The objective of the financing was to reduce high interest costs through low-cost section 936 financing. And the Puerto Rico Economic Development Administration promptly endorsed the project, however, since there were no regulations issued under section 936(d)(4) at the time, a no objection letter had to be obtained from the IRS and Treasury. The IRS and Treasury turned the project down since they decided for policy reasons that they did not want to permit refinancings.

I then worked on a second transaction for Air Jamaica which involved arranging $51 million in section 936 financing for the acquisition of two aircraft. The transaction was approved by Puerto Rico and after several months of negotiations with IRS and Treasury, which cost Air Jamaica excessive legal fees, IRS issued a no objection letter.

And the transaction closed in August of 1989 and is expected to save Air Jamaica several million dollars of interest expense.

The fourth transaction was a $13 million loan to the Barbados Telephone Co. for the upgrading of their telecommunication network. All approvals were promptly obtained for this transaction back in 1988 and due to internal constraints of the company, the documentation for the transaction was only completed recently. The closing of this transaction is expected within the next couple of weeks.

Now, the administration problems arising out of the lack of any significant guidance, under section 936(d)(4) and the need to rely on no objection letters issued by IRS working in conjunction with Treasury have been somewhat relieved since the issuance of the temporary regulations.

It might be useful, however, for me to suggest several ways in which the original intent underlying section 936(d)(4) can be encouraged.

First, the U.S. Government agencies need to work closer with the section 936 program to provide guarantees. Second refinancing of sovereign debt should be permitted with section 936 funds since many of these countries are saddled with high levels of commercial bank debt.

The slightest decrease in interest costs would save millions of dollars of interest expense to them annually.

And third, privatization is surely a goal well within the parameters of the CBI objectives. The utilization of section 936 funds for such purposes should be permitted under specified conditions.

In conclusion, as demonstrated in my testimony, not until the issuance of temporary regulations where there are ground rules established and made public to potential borrowers. Now, that section 936(d)(4) temporary regulations have been issued and more countries have signed the TIEA, the Tax Information Exchange Agreement, we should witness an increase in Caribbean section 936 loan activity.

To illustrate this point, BT Securities is currently working on more than $300 million in CBI projects. This is largely attributable to these recent developments. Favorable consideration by amending the regulations, if necessary, in accordance with the recommendations discussed will further improve the likelihood that the objectives of the Caribbean Basin 936 lending program will be achieved.

I thank you, Mr. Chairman and members of the committee for giving me the opportunity to testify and I would be pleased to answer any questions you may have.

[The statement of Mr. Burns follows:]

STATEMENT

OF

CARLOS A. BURNS, VICE PRESIDENT
BT SECURITIES CORPORATION - PUERTO RICO BRANCH
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

APRIL 3, 1990

Mr. Chairman and Members of the Committee:

My name is Carlos Burns, Vice-President of the Puerto Rico Branch of BT Securities Corporation, a subsidiary of Bankers Trust New York Corporation, a bank-holding company, headquartered in New York City.

The recently organized Puerto Rico Branch of BT Securities Corporation has offices in San Juan and is engaged in the merchant/investment banking business in the Caribbean Basin. The views expressed herein are my personal views and are not necessarily those of BT Securities Corporation. Prior to joining BT Securities in December of 1989, I was an executive with another investment bank in Puerto Rico where I devoted nearly 100% of my time over the last three years developing 936 loans to eligible Caribbean recipients.

As you know, with the support of the Commonwealth of Puerto Rico, Section 936(d)(4) was enacted by the Tax Reform Act of 1986 "primarily to help promote economic development in qualified countries in the Caribbean region by allowing funds of possessions corporations to be invested not only in the U.S. possession where the possessions corporation conducts its business, but also, after 1986, in business and development projects in these Caribbean countries." (As stated in the Preamble to the Temporary Regulations under Sec. 936(d)(4) issued September 21, 1989 (TD 8268). The hearings today implement the intent of Congress "to exercise its oversight jurisdiction to review periodically the operation of the possession tax credit to ensure that the goals of economic development in both the possessions and the Caribbean Basin are being achieved." (General Explanation of the Tax Reform Act of 1986 (5/4/87), p. 1005.)

Quite candidly, the first three years from the enactment of Sec. 936(d)(4) in October 1986 to the issuance of the Temporary Treasury Regulations under that Section in September 1989 were exceedingly frustrating from the perspective of an investment banker seeking to promote the utilization of Sec. 936 funds in Caribbean Basin Initiative ("CBI") countries. During this period, to date, I was involved in the structuring of transactions totalling over $170 million, of which two were turned down by various government agencies, one closed on August 28, 1989 and another is closing this month. These are briefly summarized as follows:

(1) Jamaica Free Zone. At the request of the Jamaican Government in the Spring of 1987 I agreed to arrange 936 financing on a best efforts basis for a 726,000 square foot industrial park, to be known as the Spanish Fort Free Zone. Due to lack of factory space in government-owned free zones and the Government of Jamaica's interest in allowing the private sector to participate in free zone development, the Spanish Fort Free Zone was to be the first privately owned free zone in Jamaica. It was estimated that the free zone would employ more than 15,000 Jamaicans in the high unemployment area of Spanish Town and provide badly needed factory space for foreign companies to set up their facilities. Foreign exchange generated through dollar lease payments paid by the tenants could have been used to bolster the country's foreign exchange position or repay foreign debt.

Endorsement of the project was sought from the Government of Puerto Rico and the U.S. Treasury Department. In 1987 the Government of Puerto Rico endorsed the project. Since there were no published regulations under Sec. 936(d)(4) at the time, the IRS provided a "no objection" letter in favor of the project. Although approvals were obtained to use 936 funds for the project, it was necessary to find an institution which would accept the credit risk of the project and guarantee the investing 936 companies that interest and principal would be promptly paid as required. Guarantees were solicited from the Overseas Private Investment Corporation, the Agency for International Development, Eximbank and the Government Development Bank of Puerto Rico. None of the agencies and institutions mentioned would provide guarantees, either for policy reasons or due to lending limitations. Without the appropriate guarantees the financial institutions and 936 companies in Puerto Rico were not willing to invest the 936 funds in the free zone and, consequently, the project was never constructed.

(2) Proposed Refinancing of Air Jamaica Leases. The next project in 1988 entailed the refinancing of the debt of several aircraft finance leases totalling $90 million for Air Jamaica, the national airline of Jamaica. The objective of the financing was to refinance the leases with 936 funds to reduce lease interest costs. Such refinancing would have generated several million dollars for Air Jamaica which could have been used for a down payment on new aircraft, to reduce debt or to obtain other equipment. With the support of the Puerto Rico Economic Development Administration, meetings were held with the U.S. Treasury Department and the IRS. Since regulations had not then been issued under Sec. 936(d)(4), each transaction had to be approved by the IRS. The financing request was eventually turned down by the IRS since it decided as a policy matter that 936 funds could not be used for refinancings.

(3) Second Air Jamaica Transaction. Later in 1988 I was asked by Air Jamaica to raise 936 funds for a $51 million, ten-year finance lease for the acquisition of two aircraft. The financing was approved by the Puerto Rico Economic Development Administration and supported by the Puerto Rico Commissioner of Financial Institutions. Approval was then sought from the IRS and U.S. Treasury. After several months of negotiations, meetings with Treasury and IRS, and reconfiguring the structure of the financing, the IRS finally provided a favorable "no objection" letter for the project. The Air Jamaica notes were issued and the funds disbursed on August 28, 1989. The absence of Sec. 936(d)(4) regulations at the time caused several months of unnecessary delays and legal fees in excess of $300,000. Since the notes were guaranteed by the American Express Bank and the Sanwa Bank, they were "AA" rated by both Moody's and Standard and Poors. The ratings were required in order to meet the investment requirements of the 936 company investors and the Puerto Rico financial institutions. The actual weighted average 936 rate which the notes were issued on the day of the closing was 7.60%. the 936 rate obtained for Air Jamaica was 1.34% cheaper than the base rate (90 day LIBOR) which would have been used to conventionally fund the aircraft leases. For comparison, interest rates for 90 day Treasury Bills on the same day were 8.25% which was 65 basis points higher than the 936 rate achieved for Air Jamaica. The note issue is expected to save Air Jamaica several million dollars over the life of the financing, thus conserving valuable foreign exchange for Air Jamaica and the country.

(4) Barbados Telephone Company. This project involved a $13 million loan for the Barbados Telephone Company for the acquisition and upgrading of telecommunication equipment, with repayment to come three years from drawdown. A "no objection" letter was initially issued in August of 1988. Due to internal delays at Barbados Telephone and a subsequent restructuring of the facility, loan documentation was not completed until March, 1990, and the closing of the loan is expected within the next two weeks. The 936 funds will be disbursed by the Scotia Bank de Puerto Rico at the rate prevailing at the time of drawdown.

It is appropriate at this point to comment on the lessons learned from these and other proposed financings:

(1) The third project, the second Air Jamaica transaction, highlights the desirability of improving the mechanics and procedures of making qualifying loans. Since Sec. 936(d)(4) limits the investment in Caribbean 936 loans to financial institutions, 936 companies could not directly invest in the notes or bonds issued by Air Jamaica and receive tax exempt interest income, as is the case with other qualifying investments routinely made by 936 companies. This required the organization of a special purpose financial institution in Puerto Rico which issued its notes to 936 companies and financial institutions. The special purpose financial institution then funded the lease with the proceeds of the note issue. This financial intermediary limitation of Sec. 936(d)(4) is not only cumbersome but also adds unnecessary legal expenses.

It would clearly be helpful to permit direct lending to qualified projects by 936 companies, thereby facilitating the lending process, reducing administrative burdens and reducing financing costs by removing the mark up on interest costs by financial intermediaries. It should be possible to develop acceptable compliance and surveillance procedures to assure utilization of 936 funds in the required manner.

Note particularly that due to the restrictions of Sec. 936(d)(4), a special purpose financial institution has to be created for each securitized financing. This is a very expensive and cumbersome procedure. The Government of Puerto Rico as of January 1990 created an agency (the Caribbean Basin Finance Authority), specifically to issue notes or bonds to 936 companies, financial institutions and individuals in Puerto Rico. It is anticipated that this agency when fully operational may eliminate the difficulties caused by Sec. 936(d)(4) and reduce the cost of issuing debt securities for Caribbean projects provided that the agency does not charge substantial fees for its services.

(2) The biggest impediment to 936 lending in the Caribbean and lending in general to CBI countries is illustrated by the first project, the Jamaica Free Zone, that is, the difficulty of obtaining guarantees to reassure investors that the funds will be repaid in a timely manner. The Agency for International Development and other agencies should be encouraged to work closely with the Puerto Rico 936 Caribbean lending program to provide guarantees for worthwhile and well-structured projects.

(3) The second project - Air Jamaica - illustrates the obstacles imposed by a limitation preventing the refinancing of existing debt.

The administrative problems arising from the lack of any significant guidance under Sec. 936(d)(4) and the need to rely on the issuance of "no objection" letters by IRS working in conjunction with the U.S. Treasury Department have been somewhat relieved since the issuance of Temporary Regulations. It might be useful, however, for me to suggest several ways in which the original intent underlying Sec. 936(d)(4) can be encouraged. Some of the items pointed out as impediments during the interim, non-regulations period remain. Their resolution requires a mix of tax legislative and regulatory initiatives and improved support by U.S. governmental agencies involved in the development process:

(1) Direct lending should be permitted for qualifying loans though the Caribbean Basin Finance Authority authorized in January may provide a viable alternative if its fees do not become excessive.

(2) The biggest obstacle to 936 lending in the Caribbean and lending in general to the Caribbean is the lack of guarantees to reassure investors that the funds will be repaid in a timely manner. The U.S. Agency for International Development should work closely with the Puerto Rico 936 Caribbean lending program to provide guarantees for worthwhile and well-structured projects.

(3) Prior to the publication of the temporary regulations, determining what could be approved was a very expensive and time-consuming process which has caused frustration for the Caribbean borrowers. This was the experience with the Air Jamaica financing. While the Government of Puerto Rico provides potential Caribbean borrowers support in at arranging approvals from the Government of Puerto Rico, historically no legal assistance at

working through the maze of federal regulations has been given to potential Caribbean borrowers at the Washington level. It is my view that for those projects which may not directly fit the newly-drafted temporary regulations, but are worthwhile projects, the relevant Federal agencies should be encouraged to be more supportive and assist in the structuring of acceptable proposals in a non-adversarial manner.

(4) The biggest advantage that 936 funds can provide a developing country is the lower interest rate intrinsic to 936 funded loans. Depending on market conditions, 936 interest rates can be as much as 1.25% to 2.0% less than conventional interest rates. For large projects 936 funded loans can save Caribbean borrowers a considerable amount of interest.

The CBI countries which have signed the tax information exchange agreement necessary for eligibility to receive 936 funds are saddled with substantial levels of external debt owed to commercial banks around the world at high rates of interest. Even a slight reduction in interest rate levels would result in savings of millions of dollars in interest. I recommend that those countries which have signed information exchange agreements should be allowed under the Sec. 936(d)(4) regulations to refinance their external commercial debt using 936 funds. Such refinancings would save millions of dollars of scarce foreign exchange reserves which could be channeled by those governments to such basic needs as housing, infrastructure and education.

(5) One of the questions which I was requested to answer in my testimony is: "What is the potential for the use of commercial loans to finance infrastructure projects?" I believe it would not be in line with basic commercial bank lending principles to use medium term five to eight year financing from commercial banks to finance infrastructure projects which require 15 to 30 year repayment terms. This is what got commercial banks into financial difficulty throughout the developing world. However, if developing countries in the Caribbean had access to stable, long-term financing for infrastructure projects as do municipalities and federal agencies in the United States, such projects in the Caribbean could be properly financed. Proper tenor financing for infrastructure projects can only be provided through bond issues of 10 to 30 years tied to specific projects with sufficient cash flows or tax revenues to repay such bond issues. By accessing 936 funds through the newly-created Caribbean Basin Finance Authority, proper tenor matching may be achieved through the variety of investors which the agency could reach. Due to market practices, 936 companies will invest for maximum terms of five to eight years.

Commercial banks and brokerage houses will invest for terms of five to a maximum of ten years. Individual investors in Puerto Rico have been known to invest up to 30 years, provided that the investment has tax exempt features in Puerto Rico. As is the case in all 936 loans to the Caribbean, proper guarantees must be arranged which would be acceptable to the investors. Thus, through the type of investor base of the Caribbean Basin Finance Authority, infrastructure projects in the Caribbean could be properly financed.

(6) The Temporary Regulations limit qualifying investments to debt instruments. The realities of the Caribbean Basin market and the need for greater flexibility in attaining the CBI goals suggest the desirability of extending favorable treatment under Sec. 936(d)(4) to equity-type instruments, including those arising in debt-equity swaps and joint venture interests.

(7) The "privatization" of enterprises currently owned by CBI countries - that is, the transfer of assets from the public to the private sector - is surely a goal well within the parameters of CBI objectives. The utilization of 936 funds for such purpose should be permitted under specified conditions.

In conclusion, as demonstrated in my testimony, not until the issuance of the Temporary Treasury Regulations were the ground rules of the program established and made public to potential borrowers. Now that the Sec. 936(d)(4) Temporary Regulations have been published and more countries have signed the tax information agreement, we should witness an increase in Caribbean 936 loans activity. BT Securities' current backlog of Caribbean financing projects totalling more than $300 million is largely attributable to these recent favorable developments. Favorable consideration, by amending legislation if necessary, of the recommendations discussed, will further improve the likelihood that the objectives of the CBI initiative will be achieved.

Chairman PICKLE. Thank you, Mr. Burns.

May I ask you gentlemen, I guess Mr. Wadsworth, you testified first here, and I want to ask you how much money does Chase Manhattan have on deposit from the section 936 fund?

Mr. WADSWORTH. Approximately $1.2 billion.

Chairman PICKLE. That is $1.2 billion.

Is that a rather constant figure plus and minus that fluctuates a little?

Mr. WADSWORTH. It has reached a high of $1.5 billion and a low of $1 billion in the past 2 years.

Chairman PICKLE. Now, in what form are those deposits?

Mr. WADSWORTH. These are deposits from 936 companies and probably 75 percent of those deposits are for 90 days or less.

Chairman PICKLE. 90 days, CD's?

Mr. WADSWORTH. Yes, sir.

Chairman PICKLE. About 75 percent of them?

Mr. WADSWORTH. Approximately 75 percent of them would be CD's issued for tenures of 90 days or less and the balance in excess of 90 days.

Chairman PICKLE. All right now, would that be typical of Citi-Bank too?

Mr. WADSWORTH. I would suspect so, yes.

Chairman PICKLE. You would think it would be approximately the same thing?

Mr. WADSWORTH. Yes, sir.

Chairman PICKLE. All right, Mr. Wadsworth, you had, I understand, financed the AT&T underwater cable project?

Mr. WADSWORTH. Yes, sir.

Chairman PICKLE. Is there any doubt in your mind that that project would have gone ahead even if you had not financed part of it with section 936 funds?

Mr. WADSWORTH. I suspect the project would have gone ahead.

Chairman PICKLE. It would have gone ahead?

Mr. WADSWORTH. Yes, sir.

Chairman PICKLE. Then why were section 936 funds used for that one segment?

Mr. WADSWORTH. The total project was $180 million, the total cost of the installation and after thorough review by the Treasury Department, $17 million was determined to be eligible for 936 and the ultimate benefit to AT&T was cheaper financing.

Chairman PICKLE. Well, why did not AT&T just go to the open market to get that loan, to get that money?

Mr. WADSWORTH. Well, they obtained 936/CBI moneys cheaper than they would have obtained them from other sources?

Chairman PICKLE. How much cheaper?

Mr. WADSWORTH. I really do not know. As a rule of thumb, I would say that the 936 moneys are 1 to 2 percentage points cheaper than other types of sources, but it would depend upon the borrower's ability to raise funds.

Chairman PICKLE. I think that 2 percent is probably the figure that we get and that is what you are saying there.

Mr. WADSWORTH. Yes, Mr. Chairman and it might be a little bit less in the case of AT&T.

Chairman PICKLE. Well, now your testimony indicates that Chase Manhattan has reviewed over 20 proposals to lend 936 funds for use in the CBI region.

Mr. WADSWORTH. Yes, sir.

Chairman PICKLE. Now, 17 of them did not get funded.

Mr. WADSWORTH. That is correct, sir.

Chairman PICKLE. Why was that?

Mr. WADSWORTH. The principal reason that the projects were not approved by us was the underlying risk factor in the transaction. And principally the risk is that of country risk, that is, the cross-border exposure of lending dollars to an entity.

Chairman PICKLE. But the risk factor was a major thing?

Mr. WADSWORTH. Yes, sir.

Chairman PICKLE. Well, now in the Rose Hall Hotel project, of $6 million, you funded the renovation of that hotel. And but you had a guarantee from OPIC?

Mr. WADSWORTH. Yes, sir.

Chairman PICKLE. How did you get that guarantee?

Mr. WADSWORTH. Well, we have been contacting, since the program began, we have been very actively discussing opportunities with Washington agencies, both U.S. Government agencies and multilateral agencies.

And OPIC, as a matter of their own decision, decided to support the privatization program of Jamaica hotels.

Chairman PICKLE. Well, now, do you consider that a sort of a double-dip guarantee?

Mr. WADSWORTH. Excuse me?

Chairman PICKLE. Do you consider that a sort of a double-dip guarantee?

Mr. WADSWORTH. I am not sure that I understand what you mean by a double-dip.

Chairman PICKLE. Well you have got this project financed. And you have got the guarantee from OPIC?

Mr. WADSWORTH. That is correct.

Chairman PICKLE. So that means that you have got section 936 funds that have been on deposit?

Mr. WADSWORTH. Yes, sir.

Chairman PICKLE. Which are tax-exempt and now you make that loan and you also get a guarantee for that as a loan.

Mr. WADSWORTH. The issue, Congressman, is credit risk.

Chairman PICKLE. Is what?

Mr. WADSWORTH. Is risk, credit risk. On what basis do we extend credit? And if the OPIC guarantee had not been available for Rose Hall, we would not have made the loan.

Chairman PICKLE. Well, I am going to ask that question of all of the different groups.

I have a question of Mr. Burns, and I want to ask him, and then I want to go to the general questions.

Mr. Burns, do you know the interest rate that was paid by Air Jamaica to a leasing agent on this Air Jamaica project?

Mr. BURNS. I am not, I do not know the exact interest rate, but I will say this, that Jamaica went through a bidding process before the leasing company was selected and my investment bank actually bid on that transaction and we were eliminated originally to

lease the aircraft because our fees were too high. And in addition, a number of other institutions bid on it.

Chairman PICKLE. When you say it was high, do you know how high? Do you know what the rate was?

Mr. BURNS. Well, I think at the time we were asking about 2.5 to 3 percent of the actual amount of the aircraft that was going to be financed. I believe that was the number as it has been about 3 years now.

Chairman PICKLE. Well, we have been informed that the interest rate might be as much as $1.2 million annually, and is that approximately correct or do you know?

Mr. BURNS. Sir, are you talking about the interest rate or the interest received by the leasing company?

Chairman PICKLE. Well, are you asking me a question or are you making a statement?

Mr. BURNS. I am trying to get a clarification, sir. Is it an interest rate you are asking me for, or an actual amount of interest?

Chairman PICKLE. Well, I am asking you was the interest rate annually approximately that amount?

Mr. BURNS. I believe so. The interest, the actual lease fee, I guess is the correct terminology, that the leasing company received was approximately, I believe in that neighborhood.

Chairman PICKLE. Well, now, in your testimony, your written statement that you gave our committee, you had indicated that a special purpose financial institution had to be created for the Air Jamaica deal.

Can you tell me why a bank in Puerto Rico could not make that loan?

Mr. BURNS. Well, the transaction because of the tenor of the transaction, because it was actually an 11-year arrangement, none of the institutions would really go out for 11 years. So the way a transaction in the 936 market is normally constructed for that kind of a tenor, you issue notes or bonds. And you can actually reach investors that are willing to go out that long.

Now, in doing that, the only way that the section 936 companies and the financial institutions which were investing in those notes could receive QPSII, that is qualified possessionary source investment income, which gives them the tax advantage, is if a financial institution, in Puerto Rico actually issued those notes.

So in order to comply with the Federal Regulations and Puerto Rico local regulations we had to go through the process of setting up a special purpose financial institution in Puerto Rico which would issue those notes and the proceeds of which would be used to fund the lease for Air Jamaica.

Now, it was the 936 companies in Puerto Rico and financial institutions in Puerto Rico which actually purchased those notes that were issued by that special purpose corporation.

Chairman PICKLE. Would you say that this was a rather round about way to finance that project?

Mr. BURNS. Absolutely, sir, and it took about 8 months to actually comply with all of the Federal regulations and Puerto Rico regulations which were required us to go that route.

Chairman PICKLE. Well, now, let me ask you gentlemen some general questions and either of you can respond.

But why do you think that there have been so few applications for loans of section 936 funds?

Mr. UBIÑAS. I am not sure what the total number of applications have been but I think there are two reasons here. One is that until very recently very few countries qualified for the loans. And second, I think it is in part, the issue of effective demands for the funds that I discussed before. There may be many uses for these funds in the CBI countries as there are in Puerto Rico, but that does not mean that all potential users are credit worthy borrowers that could have access to the funds. And that situation is exactly the same in the islands as it is in Puerto Rico.

Chairman PICKLE. Well, Mr. Wadsworth, you had indicated in an earlier statement that you consider some of these loans as risky.

Mr. WADSWORTH. Yes, sir.

Chairman PICKLE. What standards do you apply in approving or disapproving a loan of these section 936 funds?

Mr. WADSWORTH. Well, the same standards that we would apply in extending credit in Puerto Rico or for that matter, anywhere—the standard commercial bank credit judgment.

Chairman PICKLE. You would like to be loaning to somebody with a credit rating a AA rating but——

Mr. WADSWORTH. No, sir, the AA rating is that demanded by 936 companies purchasing the notes directly. Our standards are not that stringent.

Chairman PICKLE. Well, that is good.

Now, it appears to me that the only benefit that the 936/CBI loan program offers is the ability to borrow money from a commercial bank at a reduced interest rate for use in other CBI countries.

And does this program encourage entrepreneurship? Does it allow for venture capital?

Mr. WADSWORTH. Not venture capital or entrepreneurship in, I think the sense that you imply, from commercial banks. Commercial banks even in this country do not generally make venture capital loans. It might be done after a fashion in a subsidiary company where the risk evaluation is——

Chairman PICKLE. Well, you say the interest savings is up to 2 percent and so I think that we will just agree on that level.

Now, a number of the projects have been funded with section 936 funds loaned to big companies.

Mr. WADSWORTH. Yes, sir.

Chairman PICKLE. AT&T and some of the other projects.

Mr. WADSWORTH. Yes, sir.

Chairman PICKLE. What do you personally think is the potential for the use of section 936 funds by local or small borrowers?

Mr. WADSWORTH. Congressman, I think the limiting factor is the credit risk. It is the ability of a borrower whether it is a large company or a small company to satisfy standard commercial bank credit criteria. As such, the potential for small borrowers, Puerto Rican banks lending to a small borrower in a qualified country is limited unless there is some form of intermediary guarantee.

Chairman PICKLE. Well, I must assume that out of some 20 loans you have reviewed and 17 of them you refused, you had to say that this is just too risky and we just do not want to get involved in it.

So you just have not done it. So the chances for approval to a small island nation is really rather limited, is it not?

Mr. WADSWORTH. Unless some vehicle is found. And I think there are vehicles available or intermediaries.

Chairman PICKLE. Now, what is the vehicle then, a guarantee?

Mr. WADSWORTH. A guarantee agency.

Chairman PICKLE. By whom?

Mr. WADSWORTH. Well, OPIC, Inter-American Development Bank, International Finance Corporation.

Chairman PICKLE. OPIC approved yours, gave you a guarantee?

Mr. WADSWORTH. OPIC guaranteed the Rose Hall transaction.

Chairman PICKLE. Should we expect a guarantee from Puerto Rico?

Mr. WADSWORTH. I do not know what the Puerto Rican——

Chairman PICKLE. You do not figure that is your business?

Well, what special problems are involved in making loans across international borders? What are the two main problems that you would have, two or three that would prevent you from making these loans or would cause you not to approve them?

Mr. WADSWORTH. Well, I think the problems that commercial banks are having, certainly my own bank, with the LDC countries is well known. We have suffered large losses and we have had large portfolio write-downs. Brazil, Argentina, and Mexico get the headlines but the economic conditions and the debt conditions in the countries in the Caribbean are no different.

Jamaica has rescheduled its debt several times and the Dominican Republic has rescheduled its debt. The Dominican Republic has not paid its interest since May of 1989 and Trinidad right now is in the midst of an external debt rescheduling.

Chairman PICKLE. Mr. Wadsworth, one of the Treasury's regulations forbids the use of more than one intermediary bank. In other words, a loan of section 936 funds would be made by a Puerto Rican financial institution to a foreign intermediary. Why would it be important to have just one intermediary bank or should we have more than one?

Mr. WADSWORTH. I believe we should have more than one.

Chairman PICKLE. And why?

Mr. WADSWORTH. I will give you a specific example. There is an bank based in Panama, and it is called Bladex, an export financing bank and it is owned by commercial banks and central banks around the world.

And their role is to borrow money in the international capital market and lend it to regional banks, to commercial banks in the borrowing countries. We could not lend, we, Chase, could not lend 936 funds to Bladex for their lending to a local bank for that local bank to use in its community.

Chairman PICKLE. Well, if you had more than one intermediary bank, would that not increase the cost?

Mr. WADSWORTH. It would increase the cost somewhat but I think that it would be more than compensated for by the ultimate local banks intimate knowledge of that particular borrower and that local institution's ability to obtain acceptable guarantees.

Chairman PICKLE. As I understand it, Treasury has recommended just one intermediary bank?

Mr. WADSWORTH. Yes, sir, that is correct.

Chairman PICKLE. Why would they limit it just to one?

Mr. WADSWORTH. I do not know. I suspect that they were concerned about the successive cost factor as it passed on although I do not know. In my testimony 2 weeks ago, we recommended that be changed.

Chairman PICKLE. And——

Mr. UBIÑAS. Mr. Chairman, can I add to Mr. Wadsworth's comments?

Chairman PICKLE. Yes, Mr. Ubiñas.

Mr. UBIÑAS. First you mentioned the issue of whether AT&T, for example, or other borrowers have access to other sources of funds in addition to 936.

The answer to that is clearly yes. A 100 percent of the projects that get funded with 936 have alternative funding sources.

Chairman PICKLE. Well, Mr. Ubiñas, I said that it looked like the funds were going to the larger corporations and it is a good deal for them. Is it a good deal? Are section 936 funds going to be used by the small corporations?

Mr. UBIÑAS. Right, the fact that they go to the large corporations does not mean that they are not available to the smaller corporations provided they meet the credit requirements. Financial markets are as efficient as they are because resources tend to go to the cheapest financing source. That is the key to the whole thing.

Now what happens to small borrowers? It is a lot more difficult for them to have access to the funds, no question about it, but it is not impossible. And I think a way to answer that and also to answer the issue of intermediation, I think as Mr. Wadsworth described, is, for example, take a small borrower in Jamaica who may have credit with a local Jamaican bank.

And that local Jamaican bank may be willing to extend credit to that borrower but that Jamaican bank does not have access to U.S. dollars or does not have a very high credit rating. But it may have a very close relationship with a multilateral bank or a regional bank as was the case with the Central American Bank for Economic Integration, and maybe that bank would be willing to extend credit to that small bank in Jamaica.

And there for sure will be a bank in Puerto Rico that would be willing to extend credit to that multilateral bank. In this example you have got multiple intermediation yet, you are able to get the funds to that small borrower in Jamaica, albeit at a higher cost, but the key thing to remember is that absent this structure, that borrower would simply have no access to the funds.

So you are able to accomplish two things. One, is that you get funds to them; two, you get funds to them at a higher cost than what AT&T would borrow but lower than the cost of other available sources, if any. That would be normal, they are not as good a credit as AT&T.

Chairman PICKLE. Mr. Rangel.

Mr. RANGEL. Mr. Chairman, you have asked most all of the questions to show why this 936 bank loan program has not been effective.

From the answers that you received from your questions, we see banks demand the same credit requirements for 936 funds as any other bank.

The only thing that we have done is to make these funds available for people who have high credit ratings at a lower rate.

So while we beat up on Puerto Rico for not getting these moneys out there, these banks are not anxious to get that money out there unless they are dealing with people who are not credit risks.

Mr. UBIÑAS. Can I add something?

That is not entirely correct.

The banks and the financial institutions are willing to extend credit to any entity that meets the credit requirements. Typically a large borrower such as AT&T will meet that credit requirement because it is AT&T. A smaller borrower as has been the case in Puerto Rico over the last 40 years, because think about it, in Puerto Rico there are very few local companies that come even close to AT&T. You have to find additional structures that will raise the credit of that small borrower to the acceptable level.

Mr. RANGEL. Are you saying that the low interest rate would allow the loan to be affordable by bringing in an intermediary to——

Mr. UBIÑAS. Exactly.

Mr. RANGEL [continuing]. To increase the credibility of the original borrower?

Mr. UBIÑAS. Exactly, and clearly that small borrower is going to borrow at a higher cost than AT&T, but that is the way the markets work everywhere in the world.

Mr. RANGEL. Anyway, you are dealing with someone that just needed a little bit of help, as opposed to someone that was an economic basket case, and I think Mr. Wadsworth was talking about the lack of credibility of the entire nation——

Mr. UBIÑAS. That is right.

Mr. RANGEL [continuing]. And that is a consideration before you make the loan, and then you have to reach out for multinational banks, in order to give country credibility. So, it would seem to me, Mr. Chairman, that while this is certainly better than nothing, it is hardly an economic hook for a lot of small businesses that come from these countries that have their own fiscal problems, to expect that a lot of money would be going out there.

What kind of guarantees do you need, other than—I know you went to OPIC, Mr. Wadsworth——

Mr. WADSWORTH. Yes, sir.

Mr. RANGEL [continuing]. But is there anything that we could do that would not give full guarantees, but that would give encouragement to you to take some risk? I do not even know whether any risks are being taken at all by the banks? Is that not a part of doing business, to take some risks?

Mr. WADSWORTH. At the present time, the banks are laboring under their existing less developed country or third world debt portfolio, so this is not an easy time to suggest that commercial banks increase that exposure. In certain cases, that would be viewed very negatively by the regulatory authorities and certainly very negatively by the market.

There certainly are ways to structure transactions to minimize risk or to pass risk on, and I think the system can be creative to find solutions. But we must recognize that the principal impediment is this issue of the country risk and the need for other forms of support.

Mr. RANGEL. Well, if we were talking about infrastructure, if a country came and said, heck, we need an airport and we have our credit problems, but the Puerto Rican banks said they wanted to loan the money, what could we do to encourage that loan to take place? I mean we cannot get a multinational bank to come in as an intermediary and we believe that the country could do better in paying back its loans if, indeed, we were able to help the country building roads and railroads and communications systems and an airport. What could we do in the Congress to help make that loan less risky?

Mr. WADSWORTH. These loans are typically financed by international lending agencies, the World Bank, the Inter-American Development Bank, there is a Caribbean Development Bank. That is their basic role in providing infrastructure financing. Certainly, the financial system of Puerto Rico could fund or purchase securities issued by these organizations. It is not really our role. In the past, the times that we have been involved in infrastructure financing directly, we have paid the price.

The transaction that we recently concluded in the Dominican Republican was infrastructure, it was providing electrical generation capacity. A private company based in Kansas, arranged a contract with the Dominican Power Authority. We provided the financing to that Kansas company to acquire the——

Mr. RANGEL. Is there any loan that you have made that you would not have made if it was not for the 936 rates?

Mr. WADSWORTH. I am not sure what other sources the companies had access to. AT&T certainly had access to other sources of funds. This cheaper source was the Puerto Rican source. The Jamaican transaction would not have been done without the OPIC guarantee.

Mr. RANGEL. The OPIC guarantee could not have been made with the funds, other than the 936?

Mr. WADSWORTH. Yes, sir, it could have, but it would not have been cheap as the 936 funds.

Mr. RANGEL. We know they are cheaper. I just do not know whether we are really making that great contribution to the economic recovery of the Caribbean through the 936 funds.

Mr. Burns.

Mr. BURNS. Yes, I would like to comment. You asked the question would any of these loans have been made if 936 was not involved. I can say, as a result of my involvement in the Air Jamaican transaction, that if 936 funds were not used, Jamaican probably would not have those aircraft now.

It is sort of like the situation that the new home buyer has when they go into the bank looking for a mortgage and they only have an income of x and interest rates are 12 percent and they do not have a monthly income in order to repay that mortgage. However, if interest rates were, say, 8 percent, they qualify. It was the same situation there. Because of the lower interest rate, they were able

to get the credit enhancement needed in order to make that transaction actually happen.

By the way, I would like to mention that was done without any government guarantees. It was done all through the private sector and the funding that Air Jamaica received was much lower than conventional financing.

Mr. UBIÑAS. If I may add also, I do not think the Jamaica housing loan would have been done, had it not been for 936 funds.

Mr. RANGEL. Well, one thing is clear, the banks are not losing money on these 936 projects. That is clear. You do not feel that you are exposed to anything with these type of loans.

Mr. WADSWORTH. That is correct.

Mr. RANGEL. But since you are not going to expose yourself to any additional liability, so you might want to make a contribution to your country and to your national security by offering this committee some ways to be more effective in getting that money out to the entrepreneurs that we want to help. It is clear that we are helping the banks to make transactions that they would not have made if the lower rates were not there. But, you should know that, politically, that was not the intent of this committee. We did not realize all the problems that would be out there and we are not being critical of you and your fiduciary relationship, but still, the Chair and members of this committee want that money out to where we believe it will do good for the countries and the individuals in the countries that do not have the credit rating that qualifies them for less than market interest loans.

We have a debt nationally, but you people are the international experts and I would appreciate whatever information you can give us to make us reach the goals that we had hoped to obtain, but obviously are very difficult to do.

Thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Rangel.

Thank you, gentlemen. I plan to have other hearings on this thing and I am sorry that Citibank did not testify today, Mr. Wadsworth. They just called and said they just could not find anybody available to testify. I have been pondering that answer with some puzzlement.

The comment I would have to you and the other panelists, but primarily to you, is not one of criticism of your operations, because if a company has funds to deposit and they are tax-fee and you can put them in your bank, you would want to receive them, so I accept that.

We know that you have now about $1.2 billion and I assume you have had that plus or minus, for some 10 years. You have got the money on deposit, 936 funds, and yet you do not loan much of them, because you are not going to make a loan that is not a good risk and you are careful about that, which means, as a practical matter, that borrowers are not going to get a better deal coming to you than they would be going to any other source, pretty much along the lines that Mr. Rangel was suggesting.

So, it seems to me like we have got to make some substantial changes or else the small borrowers are just not going to be able to participate, or at least it would seem that way to me. Now, this bothers us and we are not here today to try to find answers to all

of these things. We are just trying to get the facts out as we see them.

Mr. Burns, we may want you to return later with respect to some questions on Air Jamaica, because I understand you were—were you with Drexel-Burnham at the time?

Mr. BURNS. Yes, I was, sir.

Chairman PICKLE. You were?

Mr. BURNS. Yes.

Chairman PICKLE. So, we may want to revisit with you about this particular project later.

Now, the Chair is going to call a recess. We have a vote on an amendment and then we may or may not have a vote on passage after that. But there are several more amendments, so what we will do, then, we will call a recess for approximately 10 minutes. We have one more panel after this and we will try to return within about 10 minutes and have this one panel and I think that will complete the testimony.

So, I thank you gentlemen very much for your testimony.

We will recess for 10 minutes.

[Short recess.]

Chairman PICKLE. The subcommittee will come to order.

The next panel consists of Mr. Carl Nordberg and Mr. Manuel Luis del Valle. Are those gentlemen here?

Mr. Carl Nordberg is the executive director of the Puerto Rico/U.S.A. Foundation, and Mr. Nordberg is to my right. Mr. Manuel Luis Del Valle is president of the Puerto Rico Manufacturers' Association.

We appreciate you gentlemen being here today. We are sorry that the hearing has gone on so long and that you have to wait until the end, but there is just a lot of interest in this issue. So, I thank you very much for coming and for waiting.

We will hear first from Mr. Nordberg. Your entire statement will be made part of the record.

STATEMENT OF CARL A. NORDBERG, JR., EXECUTIVE DIRECTOR, PUERTO RICO USA FOUNDATION

Mr. NORDBERG. Thank you, Mr. Chairman.

I am Carl Nordberg and I am a partner in the Washington, D.C. law firm of Groom and Nordberg. I also represent an organization of 70 mainland companies that have operations in Puerto Rico.

The previous witnesses you have heard here today have expressed the views of the Puerto Rican government, the U.S. Treasury Department and the Puerto Rican banks. I am going to represent this afternoon the companies that have earned and now own the much discussed 936 funds, and my testimony may come from a little bit different perspective than those you have previously heard.

First of all, I would like to set forth a little background, Mr. Chairman. The companies that operate in Puerto Rico and earn their profits there do not take all of their profits and stash them away in banks in Puerto Rico, as some might understand.

It is the common practice today for the companies that operate in Puerto Rico to repatriate to the United States at least 75 per-

cent of the profits that they annually earn in Puerto Rico. Now, when they bring these funds back here to the United States, they are being used to fund and finance very important research and development projects, as well as modernization and expansion of U.S. plant and equipment. So, I would like to make that point clear before I go on and discuss the CBI program. Sometimes we lose sight of the fact of how much the United States benefits from this 936 program.

A number of 936 companies began participation in the twin plant program in the early 1980's. The companies participated in this program because it made sense for the companies operating in Puerto Rico to do so. Many of the companies that operate in Puerto Rico need to tap the labor pools in the Dominican Republic and other countries in the CBI and twin those programs and plants with operations in Puerto Rico. In that way they were able to maintain their competitiveness by taking advantage of lower wage rates.

When the Congress enacted the 1986 act, some of the companies at that point in time were prepared and already planning to invest in the CBI area. But when the Congress enacted the 936 amendments and at the same time limited the use of 936 funds to qualified countries, the companies' investment options if they were to use 936 funds, were limited to only one or possibly two CBI countries.

The companies had to make a decision between following Congress' direction and desires to use 936 funds or to go ahead with their planned projects and use their own funds. They felt that, overall, the CBI program would be benefited if they invested in the nonqualified CBI countries, using their own funds.

As a consequence of that decision, there are 12,000 more people working in the CBI today than there were 4 years ago.

With respect to the Dominican Republic, whose representative testified here just a few minutes ago, I would point out that the companies have invested in 39 projects in the Dominican Republic in the last 4 years and have created over 7,000 jobs.

One of the things that you asked, Mr. Chairman, was why the Puerto Rican government should be given credit for these investments that the companies made with non-936 funds. As a representative of the companies, I can assure you that the government of Puerto Rico played a very significant role in encouraging and promoting those investments, and sometimes there was a very strong push on some of the companies in making those investments.

Chairman PICKLE. Mr. Nordberg, I do not question that. I think it was more than a push, it was almost a prayer and——

Mr. NORDBERG. That is right, they did sometimes——

Chairman PICKLE [continuing]. And say won't you please loan that money.

Mr. NORDBERG. Pardon me?

Chairman PICKLE. They were just saying please won't you approve this loan.

Mr. NORDBERG. Well, sometimes they did not ask please, Mr. Chairman, but we did go forward and we did make those invest-

ments in the Dominican Republic and other areas where they were nonqualified countries.

Now, another thing that I would like to mention today is that, although many of the companies did make investments in the Caribbean, a number of the companies that belong to our organization cannot make twin plant-type investments, because of the type of products that they make or because of their size. Nevertheless, those companies want to make some type of a contribution to this effort, so in the recent months we have put together an agreement, in principle, by a large number of the companies, to put together an investment fund to invest 936 funds in qualified countries, and those investments will be limited to small and medium-size business ventures. We are not going to fund large infrastructure loans, but we will——

Chairman PICKLE. Is that program consummated? Is it completed?

Mr. NORDBERG. No, Mr. Chairman. We have filed for an IRS ruling and we did that about 6 weeks ago. We expect that we will get a favorable ruling from the Internal Revenue Service on our proposal, what we call an investment partnership.

Chairman PICKLE. Why was that not done 3 years ago, Mr. Nordberg?

Mr. NORDBERG. Well, there were a number of reasons why it was not done 3 years ago. For some period of time, there was another fund that was being discussed with various companies. That fund was not acceptable to a number of the companies and, quite frankly, Mr. Chairman, that interfered with the opportunity for the companies to come forward with a fund of their own. But we have got that fund now.

Chairman PICKLE. I do not understand. What other fund was it that interfered with that?

Mr. NORDBERG. Well, it was a fund that was being promoted by one of the investment firms in Puerto Rico which would have done somewhat the same thing.

Chairman PICKLE. What funding was that? I am just not familiar with what you are talking about.

Mr. NORDBERG. What fund was it?

Chairman PICKLE. Yes.

Mr. NORDBERG. It was the Drexel/Burnham-First Boston Fund.

Chairman PICKLE. And that——

Mr. NORDBERG. That was never funded, Mr. Chairman, because the companies did not choose to participate in it.

Chairman PICKLE. But you are saying that Drexel/Burnham program that was underway really was an inhibition against moving forward on the type of funding that you have now?

Mr. NORDBERG. Yes, sir, Mr. Chairman. You could not have two of those funds moving forward at the same time.

Chairman PICKLE. Well, I wish we had Drexel/Burnham, but we will come back to him. We are going to have him back, anyway.

Mr. NORDBERG. OK.

Chairman PICKLE. Go ahead.

Mr. NORDBERG. I do think we will get this fund off the ground and we recognize that it is very difficult to find these investment

projects, notwithstanding some of the testimony that we have heard today.

I would point out, Mr. Chairman, that the World Bank has had a program of lending money into the CBI area for the last 9 years and they are professionals at this. Over those 9 years they have loaned only about $40 million to the original four qualified countries in the CBI for the type of investment programs that we are trying to get into.

Chairman PICKLE. When you say they, who is they?

Mr. NORDBERG. The World Bank. The World Bank has a program of investing in the CBI and they, over the last 9 years, as I say, they have obtained financing for 18 projects and they have invested something like $40 million.

The other thing that I would like to bring up this afternoon is that earlier the chairman spoke of the agreements that were reached in 1986. As a participant in all of that, I remember it well, and the companies were basically agreeing and understanding that they would have to continue—they were glad to do it—continue their investment and undertakings with respect to promoting and assisting in the development of the Puerto Rican economy, and, second, that they would begin to participate in the twin plant CBI program.

But there was another part of that understanding and that was reflected in the Ways and Means Committee's decision to make only minor changes in section 936.

Recently, we have been informed that the Treasury Department does not intend to adhere to Congress' determination to make only minor changes in section 936. In fact, the Treasury Department has recently taken the position that they are free to make fundamental and significant changes in 936, notwithstanding the clear legislative history, which talks in terms of minor changes. In fact, Mr. Chairman, you quoted that part of the legislative history this morning—minor changes that were insignificant.

We would ask the Chairman that the oversight responsibility be exercised not only against Puerto Rico and the companies of the private sector, but also with respect to the Treasury Department. We do not think they should be allowed to disavow the agreement that they helped put together in 1985 and 1986. The agreement at that point in time was for minor changes, minor modifications that were insignificant and the committee did not intend to make fundamental changes that were significant.

Mr. Chairman, I thank you for the time. I would be glad to answer any questions that you may have.

[The statement of Mr. Nordberg follows:]

CBI/936 Investment and Twin Plant Program
Hearings By
Subcommittee on Oversight
House Committee on Ways and Means

Testimony of
Carl A. Nordberg, Jr.
Puerto Rico USA Foundation

April 3, 1990

Mr. Chairman and Members of the Oversight Subcommittee, my name is Carl Nordberg and I am a principal in the Washington law firm of Groom and Nordberg. I also serve as Executive Director of the Puerto Rico, USA Foundation on whose behalf I appear here today.

The Foundation is an organization of mainland manufacturing companies, financial institutions and other firms which have operations or interests in Puerto Rico. Our manufacturing member companies produce in Puerto Rico a wide variety of products including electrical machinery and instruments, medical devices, pharmaceuticals, textiles and food products, and they have elected the provisions of section 936.

Section 936 companies account for nearly one-third of Puerto Rico's total workforce and nearly one-half of Puerto Rico's non-governmental employment. The presence of these companies in Puerto Rico has been chiefly responsible over the past 35 to 40 years for the transformation of the island's economy from one based on agriculture to one based on manufacturing and service industries. By creating high-paying, skilled and quality jobs, the 936 corporations have contributed significantly to the improved quality of life and standard of living that many of the United States citizens of Puerto Rico enjoy. Recently, a senior member of the Committee on Ways and Means stated, "What yeast is to bread, section 936 is to the economy of Puerto Rico".

Also, the earnings the companies have derived from their Puerto Rican operations have contributed significantly to the funds available to finance research and development projects of their mainland parent companies as well as to finance expansions and modernizations which help maintain their international competitiveness. The parent corporations of our membership employ over two million individuals on the U.S. mainland with operations in all 50 states.

The interest of the section 936 companies in the CBI investment and twin plant program predates the development period of the 1986 Tax Act. The companies whose operations are in whole or part labor intensive recognized in the early 1980's that in order for their operations to continue to be competitive it was essential that they utilize the less costly labor pools of the CBI countries in connection with their Puerto Rican operations. These initial efforts were undertaken in the form of subcontracting arrangements between the operations in Puerto Rico and those in other countries in the CBI. Following Governor Hernandez Colon's announcement of his twin plant program in early January of 1985, a number of the companies expressed their support and interest in participating in that program and began to make plans to that end.

It is not surprising that after the Congress enacted the 1986 Act amendments, which endorsed the Governor's twin plant program, these same companies were in a position to immediately implement the program. However, the companies recognized that although the program had been enhanced by the 1986 Act amendment which provided the added feature of

permitting the use of section 936 funds for investments in the CBI, that enhancement was, in large measure, eliminated by the restriction, added to the 1986 Act amendment at the suggestion of the Treasury Department, which limited the application of the amendment to loans into "qualified" countries. The effect of that amendment was to limit the use of section 936 funds initially to only one small "qualified" CBI country and later to only three additional small "qualified" countries. Moreover, a conflict was created because while the use of section 936 funds was advocated by the 1986 legislation, the economies of the four small "qualified" countries were not conducive to accepting the type of investments the companies had on their drawing boards.

After consideration of the over-all CBI policies, the companies decided that investments in viable business operations in nonqualified CBI countries which would create significant and permanent employment would be consistent with Congress' over-all CBI program and that these investments should not be canceled because they could not be made with section 936 funds. It should be noted that, when the restriction limiting the use of the 936 funds to only four small qualified CBI countries was first injected into the section 936 amendments by the Treasury Department, they were informed that unless some of the larger and more economically advanced countries became "qualified" under the CBI rules, that part of the program which involved utilization of section 936 funds was thereby precluded from reaching a level of any consequence.

In the first two years following the enactment of the 1986 Tax Act, a number of investments were made in the CBI region by a variety of companies. The companies investing early in this program included Puerto Rico's three largest 936 employers, Westinghouse, Baxter Healthcare and General Electric. The investments of these three companies totaled $21 million and created over 2500 new jobs. Also, four of our member companies made investments early on in Grenada. These companies were Abbott Laboratories, Johnson and Johnson, Schering-Plough and Smithkline Beecham. A number of the other companies of our organization have also made significant twin plant investments in the region. These companies include: American Cyanamid, American Home Products, Avon, Bristol-Myers Squibb, Eli Lilly, Merck, Pfizer, Searle, UpJohn and Warner Lambert.

Quite frankly, many of our members have found that because of the increasing wage levels in Puerto Rico and despite the benefits of section 936, their ability to compete in many product lines manufactured in Puerto Rico has significantly eroded. Therefore, twin planting has offered them the ability to remain in Puerto Rico and yet take advantage of the low-wage structures elsewhere in the Caribbean.

On the other hand, many of our member companies because of the size of their operations in Puerto Rico or because of the nature or their products manufactured there, are not in a position to engage in twin planting. Yet, these companies and others that already have made investments seek additional opportunities to share the benefits of section 936 with Puerto Rico's Caribbean neighbors. In this regard, many of our member companies have recently reached agreement in principle on establishing a Caribbean Basin investment fund which will commit section 936 monies to job creating business investment opportunities in those Caribbean countries which have established eligibility to receive such funds. The investment opportunities will be sought in small and medium-

sized projects of less than $10 million. The success of this funding approach, of course, will depend on the economic viability of these private sector projects.

In the process of developing this funding approach, we have met with representatives of numerous international lending institutions. While welcoming additional sources of project financing such as we are proposing, these experts, nonetheless, are of the view that the main problem they face in the Caribbean is not a lack of adequate financial resources but rather a lack of economically viable projects to fund. Nevertheless, we hope that we will be able to find those projects, and thus make an incremental contribution to the advancement of economic development in the Caribbean.

We have heard the criticism that the section 936 funds have not been moved quickly enough into CBI investments. Some have suggested that projects should be funded even if they involve significant risk of success. In fact, I heard one person urge that the important thing is to get funds invested even if the projects involved digging holes in the sand one day and filling them up the next. Clearly, investments and projects with little or no chance of providing permanent economic activity and permanent new jobs would be a mistake. Better that in those circumstances no investment be made.

A review of the 1986 Act legislative history makes it clear that Congress was not advocating the use of this part of the tax law to initiate a new foreign grant-in-aid program with the private funds of U.S. companies. Such a foreign aid program, which would follow foreign policy objectives established by the 936 companies and the government of Puerto Rico rather than those of the Congressional and Executive branches of the U.S. Government, would be both bad tax policy and bad foreign policy.

When considering the progress of the CBI/936 investment and twin plant program the contributions of the Government of Puerto Rico and particularly of the Governor must be recognized. First of all, the Governor established the twin plant program before it was linked to section 936 and since 1985, the Governor has consistently supported the program often with his own personal involvement and often in situations which have resulted in local political attacks. For example, the Governor has been asked why he is encouraging companies to make investments elsewhere in the Caribbean and export jobs when Puerto Rico is in need of such funds and projects. In our experience the Government of Puerto Rico has made an extraordinary effort to support the CBI/936 and twin plant program.

Finally, we believe the twin plant program would have been undertaken even if it had not been linked to the 1986 Act amendments. However, there is little question but that an understanding was reached in 1985/1986 between the Congress, the Government of Puerto Rico and the 936 companies which linked the Congress' decision to make only "minor modifications" in section 936 with the 936 companies' contribution to the economic growth of Puerto Rico and the twin plant program.

This policy decision of the Congress as well as the above-mentioned understanding is in jeopardy of being undone by administrative fiat. Recently, a senior Member of this Committee questioned the Treasury Department as to whether they were planning to interpret the 1986 Tax Act amendments in a manner consistent with Congress' policy decision and understanding. The Treasury Department's response asserts

their view that regardless of Congress' determination to make only minor changes to section 936, the Treasury Department is free to interpret the 1986 Act amendments in a way that those changes become "fundamental" and "very significant". If the Treasury Department is allowed to undo the accord of 1985/1986 in the fashion they are considering, the impact on just one of Puerto Rico's largest 936 manufacturers will exceed the amount of revenue pickup which was forecasted to be raised from all such 936 manufacturing companies. These are the very same companies who stepped forward in 1987 and 1988 to make the largest twin plant investments and create the most new jobs in the Caribbean.

I will not take the Subcommittee's time in this forum to belabor this point. However, it is a very critical issue which, I respectfully suggest, should be of the utmost concern to the Subcommittee. If the Treasury Department's position prevails and they convert Congress' 1986 Act "minor modifications" into "fundamental" and "very significant changes" then there is a substantial question as to whether the U.S. Government has lived up to its side of the 1985/1986 understanding regarding the 1986 Act amendments and the CBI/936 investment program.

Chairman PICKLE. Thank you, Mr. Nordberg.
Mr. Del Valle.

STATEMENT OF MANUEL L. DEL VALLE, PRESIDENT, PUERTO RICO MANUFACTURERS ASSOCIATION

Mr. DEL VALLE. Mr. Chairman, honorable members of this subcommittee, my name is Manuel L. Del Valle, and I am pleased to appear before you as president and representative of the 1,800 members of the Puerto Rico Manufacturers Association.

In the interest of time I will, with your permission, summarize the written testimony that I have submitted to the subcommittee in advance of this hearing.

Your task, as I understand it, is to determine the effectiveness of Puerto Rico's strategy to use 936 funds to finance economic development projects within the region designated as the Caribbean Basin Initiative area. The Initiative seeks to assist no less than 22 countries within the Caribbean region. Yet the Caribbean Basin Economy Recovery Act which created the CBI program in 1983 both opened the door and placed restrictions on the ability of the private sector to facilitate the application of 936 funds to such investments.

As my written testimony indicates, those restrictions have been formidable although not insurmountable. It is important to note as my testimony suggests that investment flows will take place provided that the economic returns compensate for the way business views the risk involved. The consideration of risk factor is therefore fundamental to how these funds are invested.

The Federal legislation, that establishes the CBI, increased that risk factor by limiting qualifications for the benefits of the CBI to nations of the Caribbean that enter into tax information exchange agreements with the United States. Thus far, only 6 countries in the region have entered into such agreement out of the 22 countries that were originally identified as being eligible for the benefits of the CBI. This limitation sharply reduces the options open to 936 companies considering private investment in projects within the region and therefore increases the risk factor.

Further, the temporary regulations promulgated by the U.S. Treasury Department in September 1989 greatly restricts the flexibility that is required to allow significant investment flows into the CBI countries through normal banking practices. Notwithstanding such limitations, the private financial community in Puerto Rico in general, and 936 companies in particular, have made every effort to direct 936 funds into productive investments within the Caribbean region.

Those efforts closely follow the initiatives taken by the government of Puerto Rico which has established various incentives to stimulate such an investment. As a result, more than 385 million in investment has already been placed in CBI beneficiary countries, of which more than 300 million represents investment by 936 companies. Those investments in 80 projects within the qualified CBI beneficiary nations are responsible for approximately 14,000 direct jobs in CBI countries and about 4,000 direct jobs in Puerto Rico.

Furthermore, the investment opportunities created represent a broad spectrum of industrial activity that provides a foundation for a more diverse and better integrated regional economy that can complete effectively in today's global reality. This investment flow have ultimate multiplier effects of significant quantitative and qualitative value for all Caribbean Basin countries and Puerto Rico.

However, it is important to note that the benefits of these investments are not only prospective of the total of more than 17,500 new direct jobs created, over 60 percent are already on company payrolls, and investments of over 220 million in new projects have already been committed to in the first 9 months of fiscal year 1990, which ends on June 30.

Such regional economic integration is of vital importance to the competitiveness of the Caribbean within the context of the new international economic reality. It has established a broader base of industrial activities that have already enhanced promotional skills, educational levels, and technical ability.

The Puerto Rican government's recent initiative to stimulate further Caribbean investment through the creation of an industrial development bond financing mechanism promises to channel more 936 funds into eligible CBI projects. These efforts guarantee that the flow of 936 funds into financing of viable industrial operations in the Caribbean will continue and increase in the future, building on the substantial achievement already accomplished.

There is no doubt that the results achieved up to now are a clear indication of the commitment of the government of Puerto Rico and the 936 companies to accomplish the purpose and objective of the CBI legislation. Given the opportunity to continue to apply our collective resources to the productive development of the Caribbean region, I am sure that the members of the Puerto Rico Manufacturers Association, working in cooperation with other segments of Puerto Rico's private sector and the government, will make a viable contribution to what must be seen as a new doctrine for economic growth in the Caribbean region.

Thank you for your attention and the opportunity to be heard on this vital issue.

[The statement of Mr. Del Valle follows:]

TESTIMONY OF MANUEL L. DEL VALLE, PRESIDENT OF THE PUERTO RICO MANUFACTURERS ASSOCIATION, BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON WAYS AND MEANS OF THE UNITED STATES HOUSE OF REPRESENTATIVES HEARING ON THE USE OF SECTION 936 FUNDS FOR LOANS IN THE CARIBBEAN REGION

APRIL 3, 1990

Mr. Chairman and honored members of this Subcommittee. My name is Manuel L. Del Valle and I am pleased to appear before you as President and representative of the 1,800 members of the Puerto Rico Manufacturers Association. I am accompanied by Héctor Jiménez Juarbe, Executive Vice-President of the Association.

On December 2, 1823, President James Monroe set forth his "Monroe Doctrine" in a message he delivered to the Congress of the United States. It established, for the first time, the view from Capitol Hill of the "American continents". In 1961, President Kennedy proposed the Alliance for Progress and for the first time there was a common agreement between the United States and 18 Latin-American countries to work together for economic development. Although the political and economic trends of the times in 1823 and 1961 were quite different, both of these instances show a marked interest by the United States in accepting that the people of the American continents must work together to design an economic and political order that improves its welfare.

The Caribbean Basin Economic Recovery Act (CBI), as enacted by the United States Congress in 1983, is a step forward on the path of economic integration for the American continents. It recognizes the uphill path that developing countries must climb in the highly complex technologically-oriented world economy. As such, it allows duty-free entry to the United States market as an incentive for investment in the Caribbean region (Antigua and Barbuda, Bahamas, Barbados, Belize, British Virgin Islands, Costa Rica, Dominica, Dominican Republic, El Salvador, Grenada, Guatemala, Haiti, Honduras, Jamaica, Montserrat, Netherlands Antilles, Panamá, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Trinidad and Tobago). This view, contrary to the old traditional paternalistic approach that centered all its strength in direct government programs, is a way to push these countries into a new wave of development by working within free market forces. Previous programs, like the Alliance for Progress, placed too much emphasis on what governments should do while practically ignoring the way the very competitive world markets work.

The most difficult task facing developing countries in implementing coherent growth strategies is building the entrepreneurship and managerial skills at a high enough level to compete in world markets. This was the case in Puerto Rico 40 years ago. The establishment of subsidiaries of world class competitive firms and the development of joint ventures in the developing countries create a demand for managerial talent and develops entrepreneurship in the long run. It builds the business infrastructure needed to make these countries face world class competition.

The Caribbean Basin Economic Recovery Act establishes that success within the current economic world order must come from the ability and desire of Caribbean countries to compete according to the established world market rules. This is, for all the Caribbean countries a tremendously difficult task indeed, but not impossible.

Economic research in the areas of economic location theory and optimization shows that location decisions for economic concerns have to do with the way that "risk taking" is viewed. It is also known, that investment flows will take place provided that the economic returns compensate for the way business views the risk involved. Puerto Rico has been a classic case in this strategy and some of the States have been successful in attracting foreign investment using this simple financing principle.

Section 936 of the Internal Revenue Code grants U. S. companies a 100% tax credit for income generated in a Puerto Rican subsidiary. This credit applies from direct or active income and to passive income derived from reinvestment of this income in eligible activities in Puerto Rico. Since January 1987, an amended Section 936(d)(4) allows Qualified Possessions Source Investment Income (QPSII) to be invested in active business assets and development projects in eligible CBI-beneficiary countries, as long as the investments are passed through eligible Puerto Rico financial intermediaries.

This strategy conveniently makes available a pool of private funds for potential investment capital with a significant discount on the market cost of capital. These lower cost funds are available for participating country members under the capital allocation efficiency rules used by financial intermediaries. Thus, projects are financed according to their prospective economic success.

Implementation of this program is indeed a delicate task requiring coordination between the U. S. Treasury Department, the Puerto Rican Government, the prospective beneficiaries and the financial intermediaries involved. Temporary regulations (i.e. Section 1.936-1ot) for the effective application of the amended Section 936 dispositions have been formulated by the U. S. Treasury Department as recently as September, 1989. (Federal Register, Vol. 54, No. 183, September 22, 1989, pp. 38970 - 38979)

It is, however, important to note that those temporary regulations themselves present a barrier and greatly limit the flexibility that is required to allow significant investment flows into the CBI countries under normal banking practices.

We, therefore, urge you to carefully study those regulations and to request that the positions presented by the private sector and the government of Puerto Rico on this matter, to the Assistant Commissioner for International Affairs of the Internal Revenue Service be presented to you for consideration. Those positions clearly indicate why and how the regulations, as they now stand, hinder rather than encourage the extension of credit to borrowers in CBI countries.

It is significant to point out that in spite of such limitations, a group of 936 companies has recently taken the initiative to establish an investment fund to make financing available to small and medium-sized projects within the CBI that require from $5 to $10 million. That initiative is yet another example of the support and commitment of Section 936 companies to the advancement of a stronger economy in the Caribbean region that is driven by the private sector. This private sector fund is separate and apart from the Puerto Rico government's recent initiative to stimulate Caribbean investment through the creation of an industrial development bond financing mechanism that will also channel 936 funds into eligible CBI projects. The Financing Authority created by law established a more effective mechanism for directing 936 funds to investment in the Caribbean.

Therefore, to the question, is the CBI-936 strategy successful enough? We must answer, and we know you will agree, that the strategy has been eminently successful under any measure or

standard of economic development and especially in light of the restrictions placed upon the program. You must consider, for example, that under the CBI legislation only Caribbean countries that have entered into tax information exchange agreements with the United States may qualify to receive the benefits provided thereby and that as of this date only six countries (Dominica, Grenada, Barbados, Jamaica, Trinidad-Tobago and Dominican Republic) have agreed to execute such information exchange agreements.

In spite of this limitation, which sharply reduces the options for productive private investment, we call your attention to the substantial investment activity that, as of January 1990, the current strategy has produced:

- 80 projects
- 4,000 direct jobs in Puerto Rico
- 14,000 direct jobs in CBI-member countries
- $386.1 million in investment in CBI-member countries
- $306.2 million of which represents 936 company investment funds.

Furthermore, the investment opportunities created represent a broad spectrum of industrial activities, such as electric and electronic, apparel and textiles, fabricated metal products, food products, paper and allied products, chemicals, printing and allied products, furniture, rubber and plastic products, stone products, utilities and petroleum refining. These activities provide the foundation for a more diverse and better integrated regional economy that can compete more effectively in today's global reality.

These investment flows have ultimate multiplier effects of significant quantitative and qualitative value for all Caribbean Basin countries and Puerto Rico. However, it is important to note that the benefits of these investments are not only prospective. Of the total of more than 17,500 new direct jobs created, over 60% are already on company payrolls and over $220 million in new projects have already been committed in the first nine months of fiscal year 1990, which ends on June 30th.

In addition to these real and substantial accomplishments, the Puerto Rico equation for regional economic growth with the active participation of our private sector has produced a climate for continued industrial development. We have become aggressive advocates for regional economic growth through promotional seminars for the twin-plant concept, through regional conferences and new alliances with Caribbean development institutions.

Puerto Rico's Caribbean development strategy has also produced significant programs to enhance promotional skills, educational levels and technical abilities to make the region more competitive.

We are very satisfied with the results of this program and very optimistic about its future. Decisions in this area are not easy and take time. However, there is no doubt that the results achieved up to now are a clear indication of the commitment of the government of Puerto Rico and the 936 companies to accomplish the purpose and objectives of the CBI legislation.

Given the opportunity to continue to apply our collective resources to the productive development of the Caribbean region, I am sure that the members of the PRMA, working in cooperation with other segments of Puerto Rico's private sector and the government, will make a valuable contribution to what must be seen as a new doctrine for economic growth in the Caribbean region.

Thank you for your attention and the opportunity to be heard on the vital issue that this Committee is considering.

Chairman PICKLE. Thank you very much, Mr. Del Valle.

Now, Mr. Nordberg, you represent 70 companies in your foundation.

Mr. NORDBERG. Yes, sir.

Chairman PICKLE. Would you classify them as the big companies in the 936 program.

Mr. NORDBERG. They run the whole gamut, Mr. Chairman, from the very——

Chairman PICKLE. Are most of them in the Fortune 500 category?

Mr. NORDBERG. I would not say most of them are. A number of them are, yes.

Chairman PICKLE. You represent nearly all of the large ones, do you not?

Mr. NORDBERG. That is true.

Chairman PICKLE. All right. How much funds would you say of the amount down there represents your foundation?

Mr. NORDBERG. How much——

Chairman PICKLE. Of the $10 billion down there now, how much of that belongs to your companies?

Mr. NORDBERG. Mr. Chairman, we have never asked the companies for that information. I would only venture a guess and say at least half.

Chairman PICKLE. Approximately half of it?

Mr. NORDBERG. Approximately half. Mr. Chairman, some of the larger companies, like for example Westinghouse, General Electric, and Baxter that are the big employers in Puerto Rico and have the major operations down there, they repatriate 100 percent of their funds. They do not have any funds in Puerto Rico.

So it varies. The funds that are left in Puerto Rico depends on what the parent company's financial situation is with respect to available financing.

Chairman PICKLE. Are a lot of your companies some of the large pharmaceutical organizations?

Mr. NORDBERG. Yes.

Chairman PICKLE. Do you agree with Treasury's statement earlier today that each $100 spent results in about $125——

Mr. NORDBERG. I certainly do not, no. I think that Treasury——

Chairman PICKLE. You say you certainly do not?

Mr. NORDBERG. I do not, no.

Chairman PICKLE. And why do you not?

Mr. NORDBERG. I do not because the Treasury Department numbers, when they make their computation, reflect only direct employment. They do not take into account the, what we call, multiplier effect. Any economist will agree that if you have 100 people in a pharmaceutical plant, those people go out and spend their money. And they produce employment in other sectors, in the food sector, consumer sector. There also are supplier industries created.

So if you want to consider that we only produce say 1.25 indirect jobs for every direct job, then it reduces Treasury's revenue or cost estimates significantly on a per job basis.

In fact, Mr. Chairman, it costs less. It costs less from a tax loss position than if those people were on unemployment.

Chairman PICKLE. I am not trying to pass judgment, Mr. Nordberg, whether those figures are accurate. But they are the figures that Treasury has agreed to. And if you differ with those, I want you to submit to our committee why you say that those figures, $100 versus $125, are not accurate.

Mr. NORDBERG. We have differed with those figures every year that they have been published.

Chairman PICKLE. All right. Now, in the case of pharmaceutical companies, Treasury says there is a ratio of about $265 for every $100. Do you differ with that also?

Mr. NORDBERG. Certainly, for the same reason. And I would also point out that on the employment multiplier effect, if you take that into account, Mr. Chairman, it just makes sense that the persons that have got the highest paying jobs, which are the people in the pharmaceutical industry in Puerto Rico, they are the ones then that go out and spend their money and create more jobs.

A person that makes $10,000 a year cannot create as many jobs as the person that makes $30,000 a year. Now, the $10,000 a year job is in one industry. The $30,000 is in the pharmaceutical industry.

Chairman PICKLE. Treasury says though there are some that get more than $32 to $100, some $265. Now, I am going to assume the Treasury figures are correct. At least they are the figures we have to accept as being accurate in our view, in our eyes, unless we can show something to the contrary.

Would you not have a more level playing field for all interested if you had wage credit instead of the deduction?

Mr. NORDBERG. No, sir, Mr. Chairman. And there is a reason why the wage credit was really defeated 4 years ago. The Treasury Department backed away from the wage credit. It was not something that they felt was a viable or reasonable proposal once they really got into it. The same thing is true of other agencies in the U.S. Government that considered it.

A wage credit just is not going to do the job in Puerto Rico where you are talking about a place where there is not cheap employment. The people in Puerto Rico make a very significant wage. And so a wage credit is not going to help them.

Chairman PICKLE. On whose authority do you say that Treasury has backed off of this and not——

Mr. NORDBERG. Well, I think if you get that file you are talking about from the Treasury Department, you will find that that is exactly what happened.

Chairman PICKLE. We anticipate getting that file. We also know that the Treasury today said, no, they would not recommend a wage credit at this time. On about four different occasions they made that clear.

Mr. NORDBERG. But they did not say they would ever recommend it either.

Chairman PICKLE. Well, they did recommend it originally.

Mr. NORDBERG. Yes, but they, as I said, they backed away from it rather promptly.

Chairman PICKLE. And I have to assume from my standpoint that did not advance because you would rather have the money down there than the wage credit.

Mr. NORDBERG. We think the program at this point in time is doing what it is supposed to do.

Chairman PICKLE. And I do not want to be in a position saying I am going to recommend wage credit. But I am just saying, looking at it objectively, that this is a factor that we should look at and ask ourselves over again, and ask Treasury that also, and the administration.

[The following was subsequently received:]

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April 9, 1990

Honorable J.J. Pickle
Chairman
Subcommittee on Oversight
Committee on Ways and Means
1105 Longworth House Office Bldg.
Washington, D.C., 20515-6305

Dear Mr. Chairman:

During my testimony at the April 3 Oversight Subcommittee hearings on the CBI/936 Investment and Twin Plant Program, several issues were raised about which I would like to provide some elaboration and clarification. These issues relate to (1) the wage credit proposal introduced and then withdrawn by the Treasury Department in 1985, (2) the real "cost" and employment impact of Section 936, and (3) the effect on the economy of Puerto Rico of a repeal of Section 936.

Wage Credit Proposal

You were correct in stating that in its original tax reform proposals the Treasury Department recommended the substitution of a wage credit for the income-based tax credit of Section 936. However, in the Fall of 1985, several months before the Ways and Means Committee took action on the Section 936 issue, the Treasury Department withdrew its wage credit proposal, recognizing that such an approach would be ineffective in creating levels of employment in Puerto Rico equivalent to those created by the income-based tax credit of current law.

There were numerous objections to the Treasury's wage credit proposal which ultimately led to its being withdrawn. These objections would apply even more forcefully today. The principal objection was that a wage credit would be ineffective in attracting labor intensive industries to locate in Puerto Rico since the island's economy had advanced well beyond the point where its competitive advantage in world markets would lie in labor intensive activities using low cost labor. Today, average hourly manufacturing wages in Puerto Rico exceed $7.00, while those in such locations as the Dominican Republic are less than $1.00 per hour. It would be impossible to fashion a reasonable wage credit which would be able to reduce the effective Puerto Rican wage cost to an amount anywhere near $1.00 per hour. In addition, because of the changing nature of the Puerto Rican economy, employment in labor intensive industries has dropped dramatically over the past 20 years while employment in high wage, high tech industries has risen dramatically.

"Cost" and Employment Impact

In its "Sixth Report on the Operation and Effect of the Possessions Corporation System of Taxation," published in March of 1989, the Treasury Department estimated that the average "tax benefit" per job created by 936 corporations in Puerto Rico was $18,523. The Treasury Department calculated this "per-job-benefit" based on 1983 figures showing total "tax benefits" for all 936 corporations of $1.6 billion and total direct 936 employment of 88,579 persons. In fact, the total employment generated by 936 corporations in Puerto Rico far exceeds the 88,579 direct jobs acknowledged by Treasury.

In its Sixth Report, the Treasury Department stated:

> The development of one industry may encourage the growth of other industries that are users of the products which it manufactures, a phenomenon called 'forward linkages.' Manufacturing also gives rise to 'backward (supplier) linkages.' Finally, the wages earned by 936-company employees may generate greater consumption expenditures than there would be in the absence of Section 936, which would increase the amount of employment in consumer-related industries.

However, the Treasury Department concluded: "This report makes no attempt to estimate the indirect effects of Section 936 because they are very difficult to evaluate." Nonsense!

For years, reputable, independent economists have urged the Treasury Department to consider the indirect employment effects of Section 936 and have provided the Department with conservatively estimated documentation regarding the employment multiplier effects of Section 936. The Department has consistently refused to give any recognition whatsoever to these indirect effects.

Estimates of the indirect employment effects of Section 936 prepared for the Puerto Rico USA Foundation by the economics and management consulting firm of Robert R. Nathan Associates project that for each direct Section 936 job created by a manufacturing corporation at least 1.75 additional indirect jobs are created in Puerto Rico's economy. These indirect jobs are in supplier and service industries and in other wholesale/retail sectors of the Puerto Rico economy. These indirect benefits to the Puerto Rican economy and to over-all employment are readily apparent to anyone who has visited Puerto Rico and seen for themselves the progress and development that has occurred in small and medium sized communities where 936 corporations have located their plants. Moreover, these indirect benefits have been confirmed by numerous other economists experienced in calculating employment multiplier effects.

Presently, there are an estimated 110,000 direct jobs that have been created by 936 corporations in Puerto Rico. Since each direct 936 job creates an additional 1.75 jobs, then the total employment impact of 936 corporations is over 300,000 jobs (110,000 direct jobs plus 192,500 indirect jobs = 302,500 jobs), or over one-third of the island's total workforce. In his testimony before the Oversight Subcommittee, Assistant Treasury Secretary Gideon estimated that the total "tax benefit" for 936 in 1989 was $1.9 billion. Using that revenue loss estimate and dividing by the total jobs created by section 936, the actual "tax benefit per job" is $6,280 ($1.9 billion revenue loss divided by 302,500 jobs = $6,280), or considerably less than the cost of maintaining an unemployed worker on unemployment or welfare.

The inability of the Government of Puerto Rico and the 936 corporations to have the Treasury Department consider the indirect employment effects of Section 936 in its analyses of the Possessions Tax Credit has been frustrating in the extreme. We would welcome the support of the Oversight Subcommittee and the full Ways and Means Committee in directing Treasury to base its future analyses on data which accurately reflect the realities of the impact of Section 936 on the economy of Puerto Rico. The Treasury Department's revenue estimates relating to reduction of the capital gains rates reflect that it can exercise realism and creativity if properly motivated.

Effect of a 936 Repeal

In your questioning of me, you referred to Mr. Gideon's estimate that the "tax benefit" of Section 936 in 1989 is esti-

mated at $1.9 billion. You suggested that if Section 936 were to be repealed this amount of money would be returned to the Treasury Department. I replied that this would not be the case since, if Section 936 were to be repealed, the Government of Puerto Rico, as the primary taxing jurisdiction, would impose a corporation tax equivalent to the U.S. corporate rate and that this tax would be fully creditable by corporations against their U.S. corporate tax liability. In other words, the Puerto Rican tax would reduce the estimated $1.9 billion revenue pick-up dollar for dollar. Also, the Treasury revenue estimate is based on the assumption that every company operating in Puerto Rico would not only remain in Puerto Rico but continue to operate at the same level. Such an estimate is absurd.

In a recent study done by the Economics Policy Group of KPMG Peat Marwick, the effect of a repeal of Section 936 was underscored even more dramatically. Although the Peat Marwick study was prepared assuming a repeal of Section 936 resulting from a change in Puerto Rico's political status to Statehood, the study's results would be equally applicable if Section 936 were to be repealed and Puerto Rico remained a Commonwealth.

If Section 936 were repealed, Peat Marwick found:

(1) Corporations established under Section 936 would be able to significantly increase their after-tax return by abandoning their existing operations and relocating in other tax-favored locations in the world. Seventy-two percent or more of the operating income of 936 corporations would be subject to relocation, and

(2) As companies choose to move off the island, the Puerto Rico economy would be seriously affected. This would increase unemployment in Puerto Rico and reduce wages throughout the economy. Between 80,000 and 145,000 private sector jobs would be lost increasing the unemployment rate to 30 percent.

Finally, it should be noted that on April 5, 1990, the Congressional Budget Office (CBO) released a study entitled, "Potential Economic Impacts of Changes in Puerto Rico's Status." Analyzing the fiscal consequences of a change in Puerto Rico's status to Statehood, the CBO said that, "Because of the great importance of Section 936 to the island's economy, loss of its provisions will lead to major changes in its economic condition."

More specifically, CBO concluded:

(1) Investment changes resulting from a loss of Section 936 would lead to a loss of between 37 percent and 47 percent of the capital and production of Section 936 corporations in the year 2,000. Unemployment would increase by 50,000 to 100,00 and GNP would fall by 10 to 15 percent.

(2) Statehood would increase taxes paid by individuals and companies in Puerto Rico to the federal Treasury, but this increase would be more than offset by higher federal transfers to island residents and governments. As a result, net transfers (spending less taxes) to the island would be nearly $18 billion higher over the nine-year period between 1992 and 2000, if no other economic changes took place.

When it suits their purposes, the Treasury determines employment and revenue estimates under what Larry Woodworth called "the ostrich method." The Treasury economists are the only economists that employ the ostrich method for purposes of determining Section 936 employment and revenue estimates and for that reason their estimates are never used if accuracy is important.

I appreciate this opportunity to clarify a number of the points that were raised during my testimony, and would be grateful if this letter was included in the permanent hearing record.

Sincerely

Carl A. Nordberg Jr.

Chairman PICKLE. Do you think that there is a national security interest in Puerto Rico from these 936 funds?

Mr. NORDBERG. Well, I think there is a national security interest in Puerto Rico.

Chairman PICKLE. Tell me in what respect.

Mr. NORDBERG. Yes, I think that Puerto Rico—and I am really borrowing on what I have heard from other people in this regard, particularly the admiral in Puerto Rico who is in charge of the Caribbean area. And it is his view that Puerto Rico is very important from a national security standpoint. He has charts and a discussion he will take you through indicating that all the tonnage in the world that moves out of the mainland gulf ports or through the Panama Canal and over to Europe or to Asia goes right by Puerto Rico. I am not the one who is qualified to speak on that subject, but I can assure you that the admiral thinks that there is national security consideration.

Chairman PICKLE. When you say the admiral——

Mr. NORDBERG. Well, there is an admiral—the Navy has an admiral in Puerto Rico who is in charge of the Caribbean area. He has changed over the years. But their position is——

Chairman PICKLE. Well, as the danger from Europe and from the Russian front gets less and less, do you still think there is the same degree of national security risk involved?

Mr. NORDBERG. Probably not.

Chairman PICKLE. You said at the beginning of your statement—you want to make the record clear, you said—that section 936 companies bring back about 75 percent of their profits to the United States.

Mr. NORDBERG. That is correct.

Chairman PICKLE. But because of the intercorporate dividends received, deductions, these profits are not really taxed.

Mr. NORDBERG. That is correct. That is how they get to be tax exempt.

Chairman PICKLE. They are not taxed, they are brought back but they are not taxed.

Mr. NORDBERG. That is correct.

Chairman PICKLE. Now, very little money then goes to the Treasury. The only way it ever gets to the U.S. Treasury is if you do declare some dividends at some given point. Otherwise, there is no money coming into the U.S. Treasury, is that not correct?

Mr. NORDBERG. That is correct.

Chairman PICKLE. Well then, what do you say is the great benefit to the United States, other than having a friend——

Mr. NORDBERG. The great benefit is that the parent companies get the use of the 75 percent of those profits they bring them back here to the United States and they use them as capital to build their businesses with, to do the research projects.

Chairman PICKLE. The benefit goes to the companies, not to the American Government, but from the tax standpoint just to the companies.

Mr. NORDBERG. Mr. Chairman, I think the benefit goes to the American people. I have heard the chairmen of some of these pharmaceutical companies that you referred to give a rather impas-

sioned speech about the research and development projects that they fund with those 936 profits.

Chairman PICKLE. I am going to yield to Mr. Rangel if he has any question at this point.

Mr. RANGEL. You yield at a wrong time when this is the first argument I have heard that profits for a company benefit the American people. But I guess that is what capitalism is all about.

So first of all, I think it is safe to say that the 936 program is the only economic development program that we have in Puerto Rico until someone comes up with something else, we are going to have to support and see whether we can improve on it. That is the domestic aspect of it.

The foreign policy, of course, was all disappointing to see that those funds that many small business people in the Caribbean countries do not have access to the funds because they have to overcome the same credit risk barriers as anybody else would, especially coming from countries that have their own financial problems.

Now, if those funds do not go to those Caribbean Basin Initiative countries with the speed which the Congress wants, then we would be left with those funds remaining in Puerto Rico. And it was my understanding that in response to a question from the chairman that you had indicated that only one-half of that, approximately half of the $10 billion that was there would be from members of your organization. And did you say that 75 percent of the firms withdrew their money?

Mr. NORDBERG. No, I did not say that, Mr. Rangel.

Mr. RANGEL. Well, let me ask the question then. What benefit is that the 936 countries to allow their funds to remain there, the profits made, earned, in Puerto Rico to be deposited in Puerto Rican banks?

Mr. NORDBERG. OK, the benefit is that the interest that they earn on those deposits is also tax exempt. It qualifies——

Mr. RANGEL. Well, I am trying to find out how important is this part of the program to our domestic side of it since we just began to move on the foreign policy on it with the tax exchange treaties and all of that. But if we did not have that, what benefit would it be to the companies to remain? I mean would that be a condition of remaining in Puerto Rico?

Mr. NORDBERG. I think absolutely.

Mr. RANGEL. Well, you cannot say absolute since a lot of the companies do not use it or cannot use it——

Mr. NORDBERG. Right.

Mr. RANGEL [continuing]. Or need the cash flow.

Mr. NORDBERG. They bring the money home. But if you did not have the tax exempt treatment on the QPSII, on the interest that is earned on those 936 funds, if they were not treated as tax exempt, the companies would bring all of their earnings home.

Mr. RANGEL. So what is happening with that money in the banks in Puerto Rico that is in support of our national security?

Mr. NORDBERG. Well, much of the money, as I discussed here earlier today, is used by the banks and the government of Puerto Rico as a large portion of the capital on which that island operates.

Mr. RANGEL. Now, you are saying that so far the 936 companies have not really participated in making it easier for Caribbean firms to get access to these 936 funds, is that correct?

Mr. NORDBERG. I think the record shows, Mr. Rangel, that the 936 companies have not themselves financed their CBI twin-plant projects with 936 funds to any appreciable extent.

Mr. RANGEL. Why would they not take advantage of those low-interest loans? Is there any prohibition?

Mr. NORDBERG. No. They will. And as a matter of fact——

Mr. RANGEL. No, I am asking why is it that they had not?

Mr. NORDBERG. OK. They have not because where they have been locating their operations, such as in the Dominican Republic, you could not use 936 funds since that was, until recently, a non-qualified country.

Now, the Dominican Republic is a good example. They now have signed their TIEA, and as a consequence, Abbott Laboratories has borrowed 936 and has begun an operation in the Dominican Republic.

Mr. RANGEL. You have heard all of the testimony. Let me clarify one thing too, as it relates to the cost sharing. I think it is clear that the congressional intent was not to repeal the cost sharing agreement that we did have. And I think that was cleared up with the exchange of letters we had between Deputy Treasury Secretary Darman and the Governor.

That does not mean that we do not have to be vigilant to make certain that Treasury does not expand its regulatory authority into legislation, but I just want to underscore that my understanding is the same as yours.

But let me say in conclusion, I think it safe to say that whenever we look at a tax bill that 936 is going to be an issue. You know it and I know it.

The question as to how many jobs are created is of the utmost importance to the Congress and more importantly to members of this committee. I think that the foundation and the 936 companies should not have to be asked to show us how many jobs are created directly and indirectly. I think that the companies are in a better position to educate this Congress than the government of Puerto Rico is. And I do hope that on the domestic end, that you are able to show us categorically that we are talking about more than 10 percent of the jobs in Puerto Rico and that we will be able to show what jobs are created as a result of our firms being there.

In addition to that, it would be helpful to this member if you would go back to your firms, member firms, and ask them to take a look at the 936 program as it relates to the Caribbean Basin Initiatives. And I do not think it is important as to whether or not the firms invest with 936 funds or invest and create those jobs because it should make a lot of sense to them. Certainly those people in the countries do not care as long as the jobs are created.

But you might be able, since the companies play a dual role—really more than that—to provide for profits for their stockholders to find a more efficient place to do business, and at the same time to maintain their base in Puerto Rico, that they might be able to share with us how we could do our job better by making that 936/CBI program work better.

We here in Washington, we listen to criticism from a lot of countries. All they know is that they have not received the money. They do not have access to the money. And you are really working with both, the country, their country, and your home base country. But I think that there is no sense talking about jeopardizing the program unless we come up with something better.

I want to thank the chairman for focusing attention on this because it is going to be in the front burner of the tax writing committee.

I want to commend you for you are doing domestically and encourage you to do a better job in assisting the Puerto Rican government as well as the Caribbean countries in taking advantage of the other parts of our program.

Thank you, Mr. Chairman.

Mr. NORDBERG. Mr. Chairman, I would make one comment on the jobs and the cost per job. The foundation has done a very extensive study on that particular subject, but it is 4 years old. And quite frankly, we did not expect—and we should have—that today this would be one of the major aspects of this committee hearing.

Mr. RANGEL. Let me try to make it abundantly clear to you: whenever this committee ever believes that jobs are not being created for our Puerto Rican citizens, you are not going to have a 936 program. And so I do not care what is on the agenda. The bottom line is is this program creating the maximum amount of jobs with the least amount of government funds to our citizens of Puerto Rico.

And you know, as I know and the Chair knows, that this Caribbean thing was just thrown in to save the program. So we are going to have to make certain not only that it works, but the members know how it is working.

Mr. NORDBERG. We will not make that mistake again, Mr. Rangel.

Chairman PICKLE. Mr. Rangel, I am almost tempted to ask you to have your words taken down.

Mr. RANGEL. What is that?

Chairman PICKLE. You said if we do not have jobs, we will not have a 936 program.

Mr. RANGEL. If we do not have the jobs, this member will not be supporting the 936 program on the record.

Chairman PICKLE. Well, I am not serious about that position of course.

Now, Mr. Nordberg, you stated again that you disagree with Treasury about the tax benefits versus the amount of salary paid because Treasury will not give credit for indirect jobs. I have been a member of this committee for some time. It seems like every time we ever look at a credit the contention is always made that though you are giving us a tax credit, you will make more money for the Treasury in the long run because it is a good investment. Everybody uses the same argument.

Treasury at some given point in time says we cannot deal in these ifs, we have got to have figures. And they use the figures that they have given us. Now, we can argue or discuss it. The fact of the matter is we do know that the tax benefit is larger than the invest-

ment, that is 100 to 125 and goes up considerably in pharmaceuticals.

Mr. Rangel is right, that if we cannot show that there are jobs being created through this program, you will not have a 936 program. Some of the Puerto Rican testimony today indicated that job creation was not part of the program, that we were talking about investments. And they were not going to limit it just to jobs. Now, I do not know that we can limit it 100 percent to jobs, but that has to be the core factor to a lot of these things.

Were you, the foundation, party to the negotiations back in 1985–86 when we were passing this bill?

Mr. NORDBERG. Yes, Mr. Chairman, I was.

Chairman PICKLE. Well now, if you were part of it, then was there a commitment on Puerto Rico to spend at least $100 million on this program?

Mr. NORDBERG. The discussion that was held this morning I thought was pretty close to the way things went. The Puerto Rican government has made an offer which involves $100 million of investments. But you have got to remember, Mr. Chairman, they were making that offer not in terms of 936 funds. This was an offer they made with respect to funds generally. Then that commitment, relating just to general funds and not 936 funds, was incorporated into the legislative process here.

You can argue about whether or not you had a $100 million commitment or whether or not you had a good faith commitment or whether or not you should take into account the non-936 funds as well as the 936 funds. It seems to me that all of that is sort of irrelevant now. What we really all ought to be doing is trying to do the very best job that we can.

If Puerto Rico and the companies invest $100 million but they could have invested $200 million, then I think they will have failed. They will have failed in what I consider to be the agreement that was reached with this committee.

I think what we agreed to do is to do the best job we could in this area. And whether it was $50 million or $100 million or $200 million, that is what we were required to do.

Chairman PICKLE. Do you think we have done the best we could under the circumstances?

Mr. NORDBERG. Well, thank you for saying under the circumstances. I think, yes, under the circumstances.

You know, when the amendments were adopted in 1986, there was only one qualified country, just one, and it was Barbados. How could one possibly expect that $100 million a year was going to be invested in Barbados? I mean that just could not have happened.

Chairman PICKLE. We did not make that assertion. We made no claim to that. But in the entire CBI area we did a get a promise by Puerto Rico that they would do that. They offered the $100 million, and now when they have got——

Mr. NORDBERG. Mr. Chairman——

Chairman PICKLE. We are not saying Barbados. We are saying the whole area.

Mr. NORDBERG. If you take——

Chairman PICKLE. Now, Mr. Nordberg, we have approved $70 million in 3 years. Is that vigorous pursuit?

Mr. NORDBERG. Wait. How much?

Chairman PICKLE. 70 million actually by December 1, 1989. Now, is three loans made in 3 years' time vigorously pursuing it?

Mr. NORDBERG. Now, Mr. Chairman, you are not taking into account the non-936 funds as well as the 936 funds. We cannot have it both ways.

Chairman PICKLE. Do you think that Puerto Rico should be given credit for that, if they make those funds direct investment?

Mr. NORDBERG. They should be given credit for that if you are going to hold them to the $100 million commitment. Because the $100 million commitment——

Chairman PICKLE. Mr. Nordberg, if that is the case, they could make $100 million in investments directly from the companies, and Puerto Rico then, will not have to do anything with the 936 funds. What is the incentive for them to loan the 936 funds then?

Mr. NORDBERG. Mr. Chairman, the point I am trying to make is that you asked me whether or not they made a commitment. And I say, yes, they made a commitment. They made an offer is what they made. But it was in terms of funds generally, not just 936 funds.

Chairman PICKLE. No. Mr. Rangel just——

Mr. NORDBERG. Yes, sir, Mr. Chairman.

Chairman PICKLE [continuing]. Asked you the question, and you said you used that figure because you were trying to save 936 funds. Nobody agrees with that.

Mr. NORDBERG. No. Mr. Chairman——

Chairman PICKLE. You admitted that a minute ago, did you not?

Mr. NORDBERG. What Mr. Rangel said is that we were trying to save 936, and he is absolutely right.

Mr. Chairman, that was the chronology of the way it happened. I was there and I participated in this thing almost every step of the way. The rules of the game changed. After the committee made its decision on this amendment, they switched the rules. And they said from now on, the emphasis is on 936 funds.

There was never any discussion of using those funds before the Ways and Means Committee acted because legally they could not do it. It was against the rules. The statute would not permit it.

Chairman PICKLE. Well, the fact is that we did have an understanding, the $100 million. Now you say that is not really important, whether it is $50, $100 million; the important thing is to do a good job. Now——

Mr. NORDBERG. No. Do the best you can.

Chairman PICKLE. I would have to say yes, we have to agree that we ought to be striving to do the best job we can.

Mr. NORDBERG. Right.

Chairman PICKLE. But I submit to you that in so striving it appears to me that we have not strived very hard when we have only approved or disbursed $70 billion here in 3 years' time at the end of 1989.

Now, there is a lot of activity out there. 936 companies and the forces involved in Puerto Rico, they are standing on a street corner now and saying don't you not want a loan. As you said earlier, they are really vigorous now, because we are looking into this question.

We are doing it not because we want to damage the overall program. We are trying to find out what is really going on.

Now, I asked Puerto Rico earlier today: should we try to set a figure that they could accomplish in any one given year? And I asked them: should we codify? I did not get a very good answer.

I ask you: should we codify by statute the amount of money to be involved?

Mr. NORDBERG. I do not think that we have had enough experience with this program to know where that number ought to be set. If you want to ask me that question 2 or 3 years from now, I think I could answer it with some resolve.

Chairman PICKLE. We had a clear understanding 3 years ago that we did not need to codify it. Now we are asking ourselves after 3 years we have not made much progress, maybe we better codify. Now you are saying you want 3 years more?

Mr. NORDBERG. Mr. Chairman, let me ask you if I can please, what number would you have put on it back in 1986 if you had known at that time that there was only one country where those funds could be invested and the country was Barbados? Would it have been $100 million or $24 million or would it have been $5 million?

Chairman PICKLE. Back in 1985–86, Mr. Nordberg, I did not recommend anything. That figure came from you folks. You are the ones who reached out and said you would take $100 million. And we are going to try to find out who really originated this. It did not come to this committee from me or anybody else.

Now, if you ask me now, I would have to say to you, well, it would seem to me that $100 million is not very much and we ought to think in terms of a higher figure. I am not recommending that, but I am going to try to study the facts first.

But when I realized that $100 million now is less than 1 percent of these 936 funds involved, 0.8 percent, what are you really doing? You have got $15 billion down there. And we created the program, the Government did, so we are one of the original either heros or the sinners, depending on how you want to look at it.

But now you have got Puerto Rico with all this money on hand, and actually Puerto Rico, by the other nations in the Caribbean area, is looked at as being the broker from our national policies of investment throughout all that area—not the Federal Government, but Puerto Rico. It is rather unfair to Puerto Rico. They have got the money, the program is there, and the funds are there.

But at the same time, you to ask yourself is it the best way to handle the money? Would we not be better if we had an aid program, that the money actually went to and let the Government distribute these funds, these credit, instead of to Puerto Rico?

It put Puerto Rico in a position where you want to help, but at the same time you are the big "papacito" or whatever we call it down there. And it puts Puerto Rico in a rather difficult position. But it does make them the brokers for the entire Caribbean area rather than the U.S. Government.

Do you disagree with that?

Mr. NORDBERG. No. I think that it does sort of place them in that position.

But going back to your question of what the number ought to be, it seems to me that how large the number ought to be should not be related to how much is on deposit in Puerto Rico. The question ought to be how much can be reasonably, thoughtfully, and wisely invested in these countries.

Chairman PICKLE. I agree in principle with that. At the same time, I have got to have a figure. I just cannot use the X factor and say we ought to just open up the good book and say, now, what figures should we use.

I would ask you, after 3 years or 4 years of experience in this program, what should we use? $300 million?

Mr. NORDBERG. No. I do not——

Chairman PICKLE. $400 million?

Mr. NORDBERG. I think they have done a terrific job in the last few months when they finally got some of these larger——

Chairman PICKLE. Oh, yes, they are getting in high gear now. Now, suppose that they had the $100 or $200 or $300 million, and suppose Puerto Rico does not expend those funds, and they do not meet that goal, just half of it, then what?

Mr. NORDBERG. They are going to make those loans, Mr. Chairman. I am fairly confident of that.

Chairman PICKLE. Well, we can all hope that that is the case. But you have had your bankers here saying they are not going to loan that money unless there is a good risk. They got a sweet deal.

Mr. NORDBERG. They are going to loan the funds that Mr. Colorado was talking about that he has promoted recently.

Chairman PICKLE. Well——

Mr. NORDBERG. Because they do not have a risk problem——

Chairman PICKLE. Well, they have not loaned them, Mr. Nordberg, they have not loaned them. They have not loaned hardly a penny unless it can be shown that there was jobs going in Puerto Rico.

Mr. NORDBERG. I hope that when you reconvene these hearings you will look at these loans—I am sure you will—and I think you will see—I know you will see—that those loans have been closed. And the reason is that those loans are to companies in situations where there is no terrible risk problem. Those loans are being made to very substantial companies, just like the AT&T loan and the others that you have questioned.

Mr. RANGEL. Mr. Chairman.

Chairman PICKLE. Mr. Rangel.

Mr. RANGEL. A lot has been made about whether or not the Puerto Rican government made a commitment of $100 million, which to me is no big figure at all, so I agree with the Chair.

But who made the agreement that we should limit it to countries that signed the Tax Information Exchange Treaty? Did that come from the Puerto Rican government?

Mr. NORDBERG. No, sir.

Mr. RANGEL. Did it come from the foundation?

Mr. NORDBERG. No, sir.

Mr. RANGEL. So when we were talking about $100 million, that was to go to the Caribbean.

Mr. NORDBERG. It came from the Treasury. That aspect came from the Treasury.

Mr. RANGEL. So even if they wanted to get out $100 million, it would be restricted to those countries that were eligible?

Mr. NORDBERG. That is right.

Mr. RANGEL. And is your testimony that only one country was eligible?

Mr. NORDBERG. That is correct. Barbados.

Mr. RANGEL. That is why you keep asking the question as to whether or not that commitment should be made of $100 million to one country?

Mr. NORDBERG. That would be absurd.

Mr. RANGEL. So now many countries have signed the Tax Information Exchange Treaty.

Chairman PICKLE. Six out of 22.

Mr. NORDBERG. Six.

Mr. RANGEL. Well, if we got $70 million out of just a couple of countries signing, then one might expect that we should really increase that ratio of loans. This is especially so, that I think you are telling the committee that these countries now can depend on the 936 companies to assist them in getting access to the funds.

Mr. NORDBERG. There is no question about that. A number of companies of our organization are very optimistic looking at that situation.

Mr. RANGEL. Mr. Chairman, I like you am disappointed that this program has not moved with the speed that we hoped that it would at the time it was enacted. We see that Treasury just recently put out its regulations. The countries have not rapidly signed up on the Tax Information Exchange Treaties.

Now for the first time the companies are going to come in and put their credit integrity on the line in order to assist these countries in getting access to the funds. So I am encouraged. And I will encourage the Chair to continue to provide oversight. But certainly from this hearing I think that we proved that there seems to be a turnaround and reason for optimism.

Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Nordberg, do you think we should have a tax treaty with each one of these little islands or nations?

Mr. NORDBERG. I think it would be a wonderful thing if we did, yes.

Chairman PICKLE. If we do not have a tax treaty, should we make loans to those countries?

Mr. NORDBERG. Well, I think so, yes. But I am not an expert on some of the problems that this government is trying to solve with the tax exchange information agreements. I am not an expert in that area. But I can see that it has been a great impediment to what we are trying to do with these 936 funds.

Chairman PICKLE. Well, we are trying to invest these moneys to help the CBI countries. The United States ought to be paying more attention to the CBI area than we have. And this is one program, and at this point it is about the only program other what AID does. So I do not think we dispute that question.

But the question has to be are we making the best use of the funds? And is it helping your foundation more than it is helping the United States or the CBI area? And I know that and you know that.

I do not profess to say that we have got the answer. But it bothers me when I look at my kind of total here where we have a revenue loss to the United States of $2 billion.

Now, you said, oh, it is not a loss, 75 percent of that comes back. We let them go down and invest, it is tax free, and then when they do send some of it back, they get to husband it again and not pay it to us unless they do pay dividends.

Now, I say to you that if that is $2 billion, it is a real figure. If we would repeal 936, the Federal Treasury would be $2 billion richer, would it not?

Mr. NORDBERG. No, sir, Mr. Chairman, it would not.

Chairman PICKLE. How would——

Mr. NORDBERG. What would happen is that if you repealed 936—let us assume that the companies then brought all their money back to the United States—but they continue to operate in Puerto Rico and earn profits.

Those profits, are earned in Puerto Rico. Puerto Rico is a separate tax jurisdiction. The government of Puerto Rico could step in and tax those moneys first. They are not going to let the Government of the United States take the first bite.

There is a principle in international taxation that the country where you earn the income gets first bite at the apple.

Chairman PICKLE. Well, Mr. Nordberg, I want to make certain that the record does not indicate that I was saying that we are going to repeal 936. I am not trying to make that point at all. But I said, if we did not have it, under normal circumstances, except for all these other investments, we would be about $2 billion in the Treasury.

Now, you may argue with me about it——

Mr. NORDBERG. No, you would not, Mr. Chairman. If you make $100 in Puerto Rico, OK, and you do away with 936, the government of Puerto Rico is going to come along and impose a tax of about $34 on every $100 of income that you make. And then the tax that the government of Puerto Rico imposes is going to be a creditable tax against your U.S. income. So the U.S. Government is going to end up with zero.

They know that. They understand that. The Treasury Department understands that in reality that is the situation.

Chairman PICKLE. Well, I want to emphasize to you, Mr. Nordberg, and to you, Mr. Del Valle, that I am not trying to be unpleasant about it. It seems to me that a great deal of improvement has got to be made in this program and perhaps in the overall approach that we have taken in the CBI area.

I am not satisfied that what we are doing is the best answer. But I am not trying to draw conclusions about what to do at this point. I do want to get some more facts on this and conduct additional hearings. I think that we will do that.

We have a lot of questions. I personally want to ask a lot of questions on how this 936/CBI program came into being. I would like to ask you and some of the others—and we intend to—what was involved with some of the White House people? What was involved with Mr. Deaver? Who actually got to finance the big bond program for Puerto Rico? Under what circumstances? What kinds of fees were made?

We have a lot of questions we would like to bring out at another date, not necessarily from you. But I think you would be familiar with nearly all of that because you have been in the very middle of it all along.

Mr. NORDBERG. That is generally correct.

Chairman PICKLE. So we are looking at the facts, and that is all we are trying to get at this point. So we will probably be visiting with you again, you and Mr. Peter Holmes, because you are trying your best to get the program going properly down there. And we think a lot of improvements—I do—could be made.

But I want to thank you and Mr. Del Valle for your testimony.

Now, Mr. Del Valle, I have been zeroing in on Mr. Nordberg more than you. I have been advised that we should vacate this room because it is supposed to be in use for somebody else at 4. So I guess we better draw this particular hearing to a close unless anybody else has any questions or any statement to make.

Chairman PICKLE. Well, I thank you very much for your testimony. The committee now stands adjourned.

[Whereupon, at 3:54 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF

STEPHEN H. LONG

DIVISION EXECUTIVE

CARIBBEAN/CENTRAL AMERICA

CITICORP/CITIBANK

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

APRIL 3, 1990

Mr. Chairman and Members of the Subcommittee on Oversight:
My name is Stephen H. Long. I am the Division Executive for the Caribbean and Latin America at Citicorp/Citibank. I want to thank you for the opportunity to share our views on the role of Section 936. Citibank has had a long-standing involvement in this region; we opened our first office in Puerto Rico in 1918. We have approximately 2,000 employees in 12 countries throughout the Caribbean and Central America. We are not only a leader in CBI lending activities, but offer a full range of banking services throughout the region in corporate, retail and investment banking.

Given our interest in the economic development of this region, we are very much in favor of the use of Section 936 as a vehicle for encouraging investments in new and exciting businesses. It has been our experience, however, that Section 936 hasn't been used to its fullest. To better carry out its mandate of attracting investments to the area, it should be broadened to include equity investments, privatization projects, and land purchases. In addition, the allowances for incidental expenditures are too restrictive. It is our feeling that by liberalizing Section 936

in the above-mentioned ways, the opportunity for even greater economic development exists.

Citibank's Section 936-CBI Financing Projects

The first CBI loan was made in 1989 to the ABC Container Ltd. on the island of Dominica. It provided financing for the construction of a manufacturing facility to produce cardboard boxes for Dominica's banana exporters. Construction of the plant resulted in the creation of 40 permanent jobs.

Earlier this year, we closed on a loan for $66.5 million to the Phoenix Park Gas Processors Ltd. on Trinidad and Tobago for the construction of a natural gas processing plant. An estimated 350 jobs will be created during the construction phase.

Two other CBI/936 financings have been approved by the Commissioner of Financial Institutions in Puerto Rico as well as the Administrator of the Economic Development Administration or "Fomento."

The first project is a hotel under construction in St. Thomas, U.S.V.I., at a cost of approximately $9 million. The second financing is for $79 million to the Caribbean Methanol Company on Trinidad and Tobago. The company is building a plant to convert natural gas into chemical-grade methanol.

Citibank has several CBI projects in St. Lucia, Santo Domingo, Panama, Trinidad and Tobago, and Jamaica in various stages of negotiations. We are not currently authorized to disclose any details of these projects. In regards to these projects on St. Lucia and Panama, we are waiting for them to complete the ratification process with the U.S. Treasury Department's Tax Information and Exchange Agreement.

All of the above mentioned projects are expected to involve long-term financing, ranging from five to ten years. They are also expected to be funded at interest rates representing significant savings over traditional financing sources available in these CBI countries. Due to limitations on the bank's cross-border risk exposure, we will obtain guarantees or insurance (through OPIC or other sources) covering political risks, currency convertability risks, and, in some cases, credit risks.

Approval Record

Since our initial involvement in Section 936, the Administrator of Fomento and the Commissioner of Financial Institutions have approved all requests submitted by Citibank. As a matter of fact, these two Puerto Rico government agencies have been extremely receptive and cooperative in dealing with our applications for approval of 936-CBI financing projects. Our experience has shown that our projects are approved within 30 days of submission. At the same time, the U.S. Internal Revenue Service has been equally as cooperative in resolving technical issues that arise. And finally, the Overseas Private Investment Corporation has been extremely helpful.

Financing and Eligibility Criteria

In considering applications for Section 936 loans, Citibank uses standard commercial and credit evaluations. Under certain circumstances, we consider the availability and desirability of obtaining credit and political risk guarantees. We also consider the loan's compliance with the substantive and technical requirements of Section 936.

Our experience has shown that within the jurisdiction of the Puerto Rican government, any project that doesn't present harmful consequences to the economy of Puerto Rico and meets the

requirements of Puerto Rican and U.S. regulations, is approved.

Impediments

Citibank feels there are two categories of impediments to the use of Section 936 funds in qualified CBI countries.

First, there are the existing limitations on the amount of "cross-border" risks that the bank can have on its books with respect to each particular CBI country.

Secondly, there are limitations imposed by Internal Revenue Services Temporary Regulations on the types of projects that can be financed with Section 936 funds. For instance, the IRS regulations prohibit Section 936 funds from being used in privatization projects or for the acquisition of land. Some suggestions on how these regulations can be liberalized are outlined below.

Infrastructure Projects

Traditional financings of infrastructure projects involved long-term borrowing in the range of 25 to 30 years. The existing investor base and tenor structure of Section 936 funds makes it extremely difficult to finance this type of project on such a long-term basis.

Suggestions

In order for Section 936 to spark more investment and development in the CBI, Citibank offers the following suggestions:

* Regulations should permit equity investments and hybrid instruments that have debt and equity characteristics. This would undoubtedly expand the universe of projects that could benefit from Section 936 financing.

* Privatization projects should be accepted as qualified investments. Transferring government enterprises to the private sector is not only for economic development, but provides an attraction for new private investments.

* The purchase of land as part of a project that includes the construction or acquisition of other qualified assets should be considered an appropriate investment.

* The allowance for incidental expenditures is too restrictive and should be increased to the following levels: 2 percent for financing costs; 10 percent for working capital loans; and 5 percent for refinancing of existing debts.

[BY PERMISSION OF THE CHAIRMAN:]

COMMENTS ON THE USE OF SECTION 936 FUNDS FOR LOANS IN THE CARIBBEAN REGION
SUBMITTED BY GEORGE A. BRIZAN, M.P.
MINISTER OF FINANCE, TRADE & INDUSTRY
GOVERNMENT OF GRENADA

COMMENTS ON SPECIFIC QUESTIONS IN RESPECT TO 936/CBI LOAN PROGRAM FOR CONGRESSIONAL HEARING

1. As it is presently structured, is the 936/CBI of substantial benefit to Grenada?

Grenada has not benefitted directly from the 936 loan program. None of the projects sent to Fomento for consideration has received funding even though it appears that Fomento may have recommended some if not all to the banks for favourable consideration. However, it is true to say that the very existence of the programme in view of the fact that Grenada having signed a Tax Information Exchange Treaty with the USA is eligible, has made this country more attractive to potential investors. Thus, many would be investors have addressed enquiries suggesting that they contemplate use of 936 Funds in their projects. It does not seem that these investors consider the funds either to be very accessible or attractive since none of them has been able to make progress with their projects but the fact that more of them have looked at Grenada as an attractive site means that the program already has positive benef!

2. What needs does Grenada have that could be satisfied with more loans of Section 936 Funds.

Grenada is attempting to develop capacity in both the manufacturing and tourism sectors as well as in some other service areas such as data processing. It therefore needs loan funds to build and equip hotels and manufacturing plants as well as to develop existing factory shells to meet the requirements for data processing. At least two of the hotel plant loans should be in the region of $10 M (US) but there will be a need for many smaller loans for smaller hotel properties in the range of $1.5 M (US) each. The conversion of a factory shell for data entry should not exceed $1 M (US) in cost. These loans are likely to be needed in the private sector although in the exceptional case a government corporation eg GIDC may be involved.

Another key sector for which loan are likely to be required is the financial sector that is to say the development financial institutions eg. Grenada Development Bank for on-lending to development projects in the areas of manufacturing, housing and tourism. Loans through such a mechanism could allow for the purchase of property, as well as provide funds for a small enterprise window under which a large portion of the loans disbursed could be for working capital which our development bank does not provide at present.

Other possible areas include infrastructural development needs eg. water, electricity and roads since the expansion of manufacturing and tourism will increase the demand for those facilities in the short to medium term. The question of whether 936 Funds can be used in this area will depend on restrictions placed by the bank on their use (eg. long term/short term call) and the availability of development financing from other sources at a more attractive rate.

3. In your view, what are the limitations of this program?

The 936 Funds loan program has many limitations. First of all the funds are supposed by nature to be short term and this makes them somewhat unattractive for international lending to developing countries which generally need funds for infrastructural development. Secondly, the current arrangements mean that the funds can only be accessed through Puerto Rican banks including the CBI trust/benefit which substantially from the tax exempt status of the funds. The borrower benefits only in that the funds are marginally cheaper than other sources.

Now, many investors feel that only 936 firms benefit from the use of 936 Funds outside of Puerto Rico. Puerto Rican banks often require as security for an overseas investment by a non 936 firm a credit enhancement from a US or international bank thus reducing the attractiveness of 936 Funds which is based on lower interest rates. (The difference may then be ½ of one (1) percent).

Even 936 firms with substantial Puerto Rican deposits have little incentive to use their own funds in CBI countries. These firms can repatriate their profits (to the USA) after five (5) years free of all taxes. If they use them in a CBI country, the future profits are liable to tax on return to the USA. There is of course no incentive for them to borrow the funds from a bank, since the interest on their loan would exceed the interest they earn on the funds kept on deposit in Puerto Rico. Thus, none of the four 936 firms now in Grenada have used 936 funds.

It seems therefore that the firms most likely to use 936 funds in CBI countries are those that operate in Puerto Rico under the 936 provisions but have very little cash reserves there and would have had to borrow to finance a plant whether in Puerto Rico or a CBI country.

Puerto Rican banks have no real incentive to lend these funds to CBI country projects which they assume would be a greater risk. Thus, the various arrangements (eg. the CBI trust) are either not in place or are not working well.

The entire program appears to be based on the assumption that there is significant excess liquidity among the banks in Puerto Rico which would cause them to want to loan funds outside of the commonwealth. This has not really been demonstrated to be the case. If this excess liquidity is not actually present the need will arise for some specific incentive to be put in place to make lending to the eligible CBI countries an attractive proposition for the Puerto Rican banks. At present it does not seem to be. It may very well be that Puerto Rico itself considers that these funds are needed in that country for social infrastructure projects eg. low cost housing.

4. What is your opinion of the way Puerto Rico has administered the 936/CBI loan program

Fomento in Puerto Rico has been extremely helpful. First of all in its efforts to explain and publicise the program and perhaps most of all in its attempts to assist the CBI countries to enable them to develop viable investment promotion programs. Fomento has also been quite active it appears in chanelling requests for 936 funds through the Government Development Bank to the various financial institutions for further processing.

On the other hand, despite these efforts the existence of the 936 program and the ways in which it can be used is still relatively unknown. In particular, there is much confusion or misunderstanding about the regulations and their interpretation. It seems quite possible that most of the projects that have been funded are those which got strong support from the Puerto Rican government so that Puerto Rico may need to exert more influence to see projects get through.

5. What changes could be made in the program to facilitate more loans of Section 936 to Grenada

(1) 936 funds invested in eligible CBI countries should benefit from a tax exemption on repatriation to the USA or

(1a) 936 firms in Puerto Rico should be allowed to invest their 936 funds directly in eligible CBI countries on the same basis as if they were invested in Puerto Rico.

(2) Puerto Rican banks should be persuaded to deposit 936 funds in regional or national financial institutions including development finance institutions for on-lending to projects especially in countries where they do not have branch offices.

(3) The CBI trust and other lending sources in Puerto Rico should be persuaded to accept gurantees from credit worthy central and regional banks (including the ECCB) if such guarantees are supported by an eligible CBI country government. The Government Development Bank of Puerto Rico should also be asked to consider joining in such guarantees so as to eliminate the need for credit enhancement.

SUMMARY

In summary the 936 program has benefitted Grenada just by its very existence and the prospects it holds for future investment. Already four (4) 936 firms have located in Grenada and it is conceivable that they may wish to use 936 funds for future expansion. Their current investment is over $2 million and they have created close to 200 jobs. There are also several prospective investors with whom Grenada has had and is having discussion. Some of them are exploring the use of 936 funds. The demise of the 936 loan program will deprive Grenada of at least some of these good prospects.

On the other hand it is clear that more effort needs to be put into the program for the potential benefits to be realised in the short term. This is probably true for both sides - the CBI countries and the US/Puerto Rico Administrations. From Grenada's point of view, a revision of the tax benefit system would be helpful. So too will more direct intervention by the Puerto Rico government to assist the banks to loan funds abroad. This may take the form of incentives or other measures but it is necessary.

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"On the Use of Section 936 Funds in the Caribbean Region"

April 3, 1990

FROM: PUERTO RICANS IN CIVIC ACTION.

LUIS P. COSTAS ELENA, ESQ.

Civic Action is a grass roots movement that with the force of more than 350,000 individually signed petitions of individual United States citizens[1] living in Puerto Rico has essentially petitioned Congress for a redress of our grievances and requested Statehood for Puerto Rico, pursuant to Article IX of the Treaty of Paris of 1898,[2] to end the present colonial status of Puerto Rico.

Because of the truncated time allowed me, I commence with the following highlights: (1) that federal, Internal Revenue Code sec. 936 is a scandalous

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(1) Persons born in Puerto Rico are automatically United States citizens, since Article 5 of the Jones Act of 1917; Act of March 2, 1917, ch. 145, 39 Stat. 951, 953. See also Nationality Code of 1940; Act of Oct. 14, 1940, ch. 876, sec. 202, 54 Stat. 1139: "All persons born in Puerto Rico on or after April 11, 1899, subject to the jurisdiction of the United States, residing on the effective date of this act in Puerto Rico or other territory over which the United States exercises rights of sovereignty and not citizens of the United States under any other Act, are hereby declared to be citizens of the United States." (emphasis added).

(2) 30 Stat. 1759: "The civil rights and political status of the native inhabitants of the territories hereby ceded to the United States shall be determined by the Congress."

waste of federal funds,[3] which the United States can and should terminate soon, even now, under the present so-called Commonwealth status; (2) that any person concerned with revenue neutrality or equality among the political status formulas in the coming plebiscite must logically at least require the so-called Commonwealth to pay the $500 million every year which the so-called Commonwealth repeatedly promised to pay annually by 1985, to the federal Treasury in lieu of federal taxation upon Puerto Rico;[4] and (3) that Statehood

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(3) See, e.g., U.S. Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, Sixth Report (March 1989); U.S. Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, Fifth Report (July 1985); U.S. Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, Second Annual Report (June 1979); U.S. Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, First Annual Report (June 1978).

(4) See, e.g., Luis Muñoz Marín, Governor of Puerto Rico, in Hearings On S.2023 and Proposed Substitute S.2708 before the Senate Comm. on Interior and Insular Affairs, 86th Cong., 1st Sess., Proposed Amendments to the Puerto Rican Federal Relations Act 37, 44 (1959): "The Commonwealth proposes ---- through this modification to begin sharing in the common burdens of the Union .... This year the Legislature of Puerto Rico, feeling that our economic progress had made it feasible to begin acting on that principle, included a proposal to the effect...."; "Are we proposing in this bill to share in the burdens of the Union? Yes; we are proposing to begin sharing and sharing increasingly as the economy of our government permits us to. This would also make Puerto Rico resemble a federated state more, not less." (emphasis added); Governor Luis Muñoz Marín in 3 United States - Puerto Rico Commission on the Status of Puerto Rico, Hearings on the Status of Puerto Rico - Economic Factors in Relation to the Status of Puerto Rico, S. Doc. No. 108, 89th Cong., 2d Sess. 25, 231 (1966): "You recollect a resolution of the Puerto Rican Legislature, of December 1962 ... that a formula be worked out whereby Puerto Rico will begin contributing a part of its increased wealth, increased production from year to year, to support the common burdens of the American union....; "that return from Puerto Rico could be about as much as the Federal tax at that time would be". (emphasis added) "Now, on the tax question, of course, you know that we, upholders of the Commonwealth are proposing that Puerto Rico begin to contribute, not in the form of taxes, to the common burdens of all parts of the American Union. It is our belief that we can make that contribution, and that if we can make it grow until it gets to whatever size it has to get according to a fair formula, it can be as much as taxes at a given time"; (emphasis added); Dr. Alvin Mayne, the economist for Commonwealth, in id. at 749: "I believe that by 1985 the contribution of $500 million to the United States might be possible - now, this is not an official statement, but it is a computation." (emphasis added).

is the only status formula that (a) categorically accepts both the rights and responsibilities of United States citizenship, and (b) that can relieve the taxpayers and voters of each of the States that you represent from the heavy and ever - increasing burden of the so-called Commonwealth of Puerto Rico. If you aid or tolerate that so-called Commonwealth in any way, you in effect crucify the taxpayers of your States, your constituents, on the cross of that Commonwealth and particularly with the nails of 936.

I now point out some of my ideas to handle I.R.C. section 936 or make adjustments after Statehood, even for those who still have some desire to maintain that federal tax expenditure:

(1) You can terminate I.R.C. sec. 936 now and substitute it with a direct federal employment program for Puerto Rico, funded with amounts below what previously escaped the federal treasury because of I.R.C. sec. 936.

(2) You can cap or segmentize I.R.C. sec. 936 and thereby stop or reduce its hemorrhage of federal funds, for example, -a- by prohibiting the use of the tax sparing credit of I.R.C. sec. 936 after a certain cut-off date, -b- by phasing-out I.R.C. sec. 936 as you phased out Western Hemisphere Trade Corporations[5] and China Trade Act Corporations,[6] -c- by excluding pharmaceutical mixing operations and electrical machinery assemblage from the definition of corporations that can use the tax sparing credit of I.R.C. sec. 936.

(3) You can eliminate 936 and substitute it with a national program of enterprise zones for all States whose statewide rate of unemployment is, for example, 14% or higher, which program would remain in place for the State until it lowered said unemployment to say 9% and maintained that lowered rate

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(5) I.R.C. secs. 921, 922 (1987).

(6) I.R.C. sec. 941 (1987).

for a consecutive period of say 5 years.

(4) You can arguably prolong I.R.C. sec. 936 intact for a short period of time after Statehood for Puerto Rico.

The above segmentization or cap approach takes into account, for example, that although pharmaceutical section 936 operations obtain 46.3% of the total federal cost of I.R.C. sec. 936, such pharmaceuticals provide only 14.8% of the employment in Puerto Rico's manufacturing sector.(7) In 1987, according to the Puerto Rico Planning Board, the chemicals and related products sector, basically pharmaceuticals, had $3,757,600,000 of the $8,661,300,000 total net income of all the manufacturing sector in Puerto Rico,(8) but chemicals and related products only had 18,000 employees of the total 148,900 employed in manufacturing in Puerto Rico.(9) The shocking fact is that the "top sixteen possession corporations accounted for 24.2 percent of the tax benefits but provided only 3.6 percent of the employment of the 378" section 936 corporations in the Sixth Annual Report of the U.S. Treasury Department on I.R.C. sec. 936.(10) Sixteen section 936 corporations obtained $100,000 or more of the federal tax expenditures of I.R.C. sec. 936 for each person they employed.(11)

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(7) U.S. Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, Sixth Report. 51, 46 (Mar. 1989).

(8) Puerto Rico Planning Board, Informe Económico al Gobernador, 1987, at A-12, Table 12 (Feb.12, 1988). See attached Exhibit A.

(9) Ibid. at IV-12. See attached Exhibit B.

(10) U.S. Department of the Treasury, Sixth Annual Report, supra. note 7, at 48.

(11) Idem. See attached Exhibits C and D.

You and I should wholly agree with the late Professor Stanley Surrey of the Harvard Law School:

> "(A) tax incentive does involve the expenditure of government funds."
>
> "A dollar is a dollar - both for the person who receives it and the government that pays it, whether the dollar comes with a tax credit label or a direct expenditure label."
>
> "(M)any incentives look, and are, highly irrational when phrased as direct expenditure programs structured the same way."
>
> "(A) resort to tax incentives greatly decreases the ability of the Government to maintain control over the management of its priorities."
>
> "(T)ax incentives do involve expenditures - 'back-door expenditures' ... and ... a legislator concerned with expenditure levels and expenditure control should not, while holding the front door shut, let hidden expenditures in through the back door." (emphasis added). (12)

I.R.C. section 936 is one immense price that the United States continues to pay so as to prop up the so-called "Commonwealth" status of Puerto Rico. Not only has the "Commonwealth of Puerto Rico never paid to the United States the annual contributions in lieu of federal taxes that Governor Luis Muñoz Marín promised in 1959[13] and reiterated in 1965[14] and that for 1985 should have

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(12) Stanley S. Surrey, Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures, 83 Harvard L. Rev. 705, 717, 721-722, 732 (1970).

(13) E.g., Testimony of Governor Luis Muñoz Marín, in Hearings On. S. 2023 and Proposed Substitute of S. 2708 before the Senate Comm. on Interior and Insular Affairs, 86th Cong., 1st Sess., Proposed Amendments to the Puerto Rican Federal Relations Act 37 (1959).

(14) Statement of Luis Muñoz Marín, in 3 United States - Puerto Rico Commission on the Status of Puerto Rico, Hearings on the Status of Puerto Rico - Economic Factors in Relation to the Status of Puerto Rico, S. Doc. No. 108, 89th Cong., 2d Sess. 233 (1966).

been $500 million[15] but the United States via I.R.C. section 936 suffers tax expenditures that amounted to 1.167 billion in 1979: 1.326 billion in 1980; 1.711 billion in 1981; 1.678 billion in 1982;[16] and $1.641 billion in 1983.[17] Accordingly, in only these two federal tax expenditure programs,[18] the cost to the United States of the present "Commonwealth" status exceeds $2 billion each year.

There is no need for further study or vacillation on I.R.C. section 936. Its utter failure to achieve its stated purpose of creating employment in Puerto Rico has been and is evident to all who wish to see. I.R.C. section 936 has not and cannot provide Puerto Rico with its desired opportunities for employment. In 1940 unemployment in Puerto Rico was 15%,[19] hovered around 20% from 1976 to 1986 and was 17.7% in 1987.[20] The sorry fact is that, as reported by the former Chief Justice of Puerto Rico's Supreme Court, in 1899 unemployment in Puerto Rico was 17%.[21]

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(15) Statement of the economist representing the position of Commonwealth in id. at 751: "We could probably make a contribution of $500 million by 1985."

(16) Department of the Treasury, the Operation and Effect of the Possession Corporation System of Taxation, Fifth Report 53, Table 4-9 (July 1985).

(17) Department of the Treasury, Sixth Annual Report, supra note 7, at 44, 45.

(18) The nonpayment of the in lieu taxes, or I.R.C. section 933, and I.R.C. section 936.

(19) Junta de Planificación de Puerto Rico, Informe Económico al Gobernador - 1977, at A-26 (Jan. 25, 1978).

(20) Junta de Planificación de Puerto Rico, Informe Económico al Gobernador - 1987, at A-33, Table 29 (Feb. 12, 1988).

(21) José Trías Monge, 1 Historia Constitucional de Puerto Rico 7 (1st ed. 1980) (University of Puerto Rico Press).

In fiscal year 1986 the number of persons employed in the entire manufacturing sector of Puerto Rico was 148,800; and in fiscal year 1987 incremented by only 100 persons to 148,900[22] which is less than the 156,000 so employed in 1980.[23] However, net interest and profits in manufacturing rose from $5.331 billion in 1986 to $6.276 billion in 1987.[24]

Since 1970 the proportion of net income paid to Puerto Rican manufacturing employees has declined from 64% to 27.5% in 1987.[25] The reason is that more and more the greatest component of net income in the exempt manufacturing sector corresponds to the low employment - high profit pharmaceutical and electrical machinery operations. In 1987 the entire number of employees in basically pharmaceutical operations was 18,000 and in electrical machinery 20,000;[26] but their respective net incomes were $3.758 billion and $1.330 billion.[27]

The aforegoing evidences grave, fundamental, mistakes in the C.B.O. Report. Whereas employment in the manufacturing sector in Puerto Rico has essentially remained stable for the past 22 years, fluctuating between 128,000 employees in 1976 to 156,000 in 1980 and 153,000 in 1988 whereas GNP has continued growing because of the exempt profit shifting of the 936 corporations, the C.B.O. Report bases its calculations on the following false presumption (p.18): "The behaviour of Puerto Rican employment is predicted chiefly on the basis of the evolution of overall GNP." The C.B.O. Report thus begins with a false basis, contradicted by the Puerto Rican Government's own historical factual data and heaps computerized assumptions and calculations onto that false basis.

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(22) Informe Económico al Gobernador, 1987, at IV-2.

(23) Informe Económico al Gobernador, 1987, at A-35, Table 31.

(24) Ibid., at A-11, Table 11.

(25) Ibid., at IV-10.

(26) Ibid., at IV-12.

(27) Ibid., at IV-7.

The reality is that the revenue costs of I.R.C. section 936 (and its predecessor I.R.C. section 931) have continued to increase but to maintain under Commonwealth about the same number of persons employed in so-called manufacturing.[28] The C.B.O. Report seems to have either not noticed, or purposely overlooked important pertinent observations of the Tobin Report:

> "It might be thought that "direct investment" is all physical investment and has built up in Puerto Rico over $5 billion of plant, machinery and equipment. Nothing could be farther from the truth. 'Direct investment' includes all increases in the net worth of external firms, including paper assets such as Commonwealth bonds. Puerto Rican mortgages, CD's in Puerto Rican banks or CD's in Guam, as well as real assets, such as factories and machinery. Although the facts are not readily ascertainable, perhaps half of the $5 billion represents financial rather than real assets.*"

> "Even when direct investment does represent real physical investment, it does not necessarily imply an increase in Puerto Rican welfare. Although investment by subsidiaries of Mainland firms does provide new output and employment, it also entails new subsidies and real infrastructure investment by the Puerto Rican government and the greater remission of profit to the Mainland. The net benefit to Puerto Rico is not automatically positive; it must be carefully estimated case by case."

> "It should be remembered that the statistic 'direct investment' does not represent a net flow of new resources into Puerto Rico. Mainland investments earn profits, which can be freely remitted from Puerto Rico. Remittances have in fact been relatively small because unremitted profits are exempt from Federal corporate income tax, and accumulated profits can eventually be 'repatriated' 'tax-free'. Puerto Rican macroeconomic accounts count unremitted profits twice, once as an outflow as if they were remitted and once as an inflow of new direct investment. Probably something like 80% of recorded direct investment in Puerto Rico is simply the accumulation of profits on past direct investments."

> "Direct investments placed in financial instruments may not represent a new flow of new resources to Puerto Rico. They may do no more than replace other funds that would otherwise have flowed into Puerto Rico into the same financial instrument. Or they may represent financial investments that are not really in Puerto Rico at all."[29] (Emphasis added.)

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(28) See Puerto Rico Planning Board tables Exhibit E and compare with Exhibits A and D. and F.

(29) The Committee to Study Puerto Rico's Finances, Report to the Governor 44, 44n. (December 11, 1975) (Chairman James Tobin of Yale University).

The C.B.O. Report furthermore gives credence to statistics that are not even believed by the people at Fomento, contrary to common sense that treats statistics of promised employment by prospective 936 corporate suitors of tax exemption in Puerto Rico for what they are - either numbers designed to influence the rapidity that governmental officials provide them with tax exemptions and other benefits, or propagandistic numbers specifically designed to influence public policy, such as elections in Puerto Rico, proposed changes in I.R.C. sec. 936, and in the present case the plebiscite and C.B.O.'s own Report. The C.B.O. Report overlooks hard, still pertinent data, for example, my own S.J.D. thesis for the Harvard Law School that 46.13% of the exempt manufacturing companies have never fulfilled their own promised employment and have violated their exemption contracts.(30)

The worst C.B.O. fault is, however, its complete inability or unwillingness to compare or analyse the status of Commonwealth, even of Enhanced Commonwealth, to the extreme of neglecting the holes and immense costs of sought Commonwealth enhancements to the United States, for example, Puerto Rican tax sparing treaties with foreign countries, the ability of the Japanese to escape via Puerto Rico the U.S. quotas on Japanese made vehicles,(31) the

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(30) Costas Elena, I.R.C. section 936 and Fomento Income Tax Exemption in Puerto Rico, published in 40 Revista del Colegio de Abogados de Puerto Rico (Puerto Rico Bar Association Law Review) 563-602 (1979) (derived from my company by company comparison, exemption decree by exemption decree, with each company's own reported employment over the years to the P.R. Labor Department). See also the other portions of this Harvard Law School thesis published in 41 Revista del Colegio de Abogados de Puerto Rico 101-148 (1980); 41 Revista del Colegio de Abogados de Puerto Rico 225-277 (1980); 42 Revista del Colegio de Abogados de Puerto Rico 611-668 (1981). See also my L.L.M. thesis for Harvard Law School, History of Federal Income Taxation in Puerto Rico - Analysis of the Possession Corporation in Comparison with Other Modes of Business Operation in Puerto Rico: An Insight into Tax Exemption, published in 36 Revista del Colegio de Abogados de Puerto Rico 477-582 (1975).

(31) See e.g., Exhibit G., San Juan Star April 1, 1990 on the diversion of Japanese made cars via Puerto Rico to the United States.

conversion of Puerto Rico into a haven for polluters, etc. Obviously, any report that omits to analyse or compare Commonwealth status is no comparison at all but a sham, easily twisted into Commonwealth propaganda.

About a decade ago I discovered and wrote in my S.J.D. thesis for Harvard Law School this still valid point:

> "I.R.C. Section 936 is not working. I.R.C. section 936 will never work. What maintains I.R.C. section 936 and Fomento tax exemptions are not benefits to Puerto Ricans since historically 'little of the profit earned by U.S. owners of Puerto Rican subsidiaries has been invested in the Puerto Rican economy' ... but the vested interests ... that benefit from those privileges."

Commonwealth assuredly repudiates the basic economic premise of permanent union, Baldwin v G.A.F. Seelig: (32)

> "The Constitution...was framed upon the theory that the peoples of the several states must sink or swim together, and that in the long run prosperity and salvation are in union and not division."

States Saint Augustine, On Free Choice of the Will: (33)

> "Our freedom then consists in submission to the truth. It is our God Himself who frees us from death, that is, from the state of sin. Truth itself, when it speaks as a man, says to those who believe in Him, 'If you remain in My word, you shall be My disciples indeed, and you shall know the truth and the truth will make you free'. The soul enjoys nothing with freedom, unless it enjoys it securely."

And such a truth is that such prosperity and security for Puerto Rico exists, and will exist, for Puerto Rico, only in the permanent union that is solely Statehood.

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(32) 294 U.S. 511, 523 (1934) (J. Cardozo) (emphasis added).

(33) Saint Augustine, On Free Choice of the Will 69 (translated by A. Benjamin & L. Hackstaff) (published 1964).

U.S. Chamber of Commerce

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Donald J. Kroes
Vice President
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May 1, 1990

The Honorable J. J. Pickle
Chairman
Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives
1105 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

The U.S. Chamber of Commerce strongly supports Section 936 of the Internal Revenue Code and fully appreciates its importance to the growth and prosperity for the residents of the Commonwealth of Puerto Rico, U.S. possessions, and nations of the Caribbean Basin. Under Section 936, if a U.S. corporation complies with certain tests, it may utilize a credit against U.S. income. The credit is equal to the portion of the tax attributable to (a) the company's foreign-source taxable income resulting from the active conduct of a trade or business in a U.S. possession (including Puerto Rico) and (b) the firm's qualified possession-source investment income.

As a result of the Tax Reform Act of 1986, income derived from certain investments in qualified Caribbean Basin Initiative countries may be included as part of a firm's qualified possession-source income.

The Chamber believes that Section 936 has become an effective incentive for spurring economic growth, particularly with respect to Puerto Rico. The incentive has contributed to the transformation of Puerto Rico from a primarily agricultural economy to a modern industrial economy. According to the government of Puerto Rico, real Gross National Product (GNP) increased for the Commonwealth at average annual rates of 5.3% and 7% in the 1950's and 1960's respectively. Recent statistics further highlight the strong growth of the Puerto Rican economy. In this regard, real GNP grew at an average annual rate of 3.7% in Puerto Rico between 1985 and 1989.

. Companies qualifying for Section 936 have greatly contributed to the economic well-being of Puerto Rico. According to the Commonwealth of Puerto Rico, these firms are responsible (directly and indirectly) for the employment of about one-third of Puerto Rico's work force and approximately one-half of the Commonwealth's non-governmental labor force. Statistics released by Puerto Rico indicate that total employment grew from 770,000 to 907,000 between fiscal years 1986 and 1989. In addition to the economic growth occurring in Puerto Rico, the Chamber believes that Section 936 will contribute to business growth and economic prosperity for citizens of the Caribbean Basin nations and U.S. possessions.

The Chamber requests that this letter be included in the April 3, 1990 hearing record on Section 936. If you have any questions regarding our position on Section 936, please call Benson S. Goldstein of the Chamber's Tax Policy Center at 463-5620.

Thank you for your consideration of this matter

Sincerely yours,

Donald J. Kroes

Donald J. Kroes

cc: Subcommittee Members
Beth Kuntz Vance, Majority Staff Director
Michael Superata, Minority Professional Staff Member

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